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IN THE

Supreme Court of the United States

OCTOBER TERM, 1959

No. 839

THE SMOOT SAND & GRAVEL CORPORATION, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

The Smoot Sand & Gravel Corporation, by its counsel, prays that a writ of certiorari issue to review the judgment entered in this case[1] by the United States Court of Appeals for the Fourth Circuit.

[1] 15 TCM 418 (1956), reversed and remanded 241 F. 2d. 197, 50 AFTR 1612 (1957), footnote 4 deleted from Court of Appeals' opinion and rehearing denied (1957), certiorari denied 354 U.S. 922, 1 L. Ed. 2d. 1437 (1957), retried and decided 17 TCM 1086 (1958), affirmed 274 F. 2d 495, 5 AFTR 2d. 626 (1960), rehearing denied (February 24, 1960).

FINDINGS OF FACT AND OPINIONS BELOW

The Report of the Tax Court Commissioner (1955) and the first (1956) and second (1958) memorandum findings of fact and opinions of the Tax Court are not officially reported but are printed in the certified transcript of record (Vol. I, 1a-73a).[2] The first and second opinions of the Court of Appeals are reported at 241 F. 2d 197, 50 AFTR 1612 (1957) and 274 F. 2d 495, 5 AFTR 2d 626 (1960). Both opinions of the Court of Appeals, including the subsequently deleted footnote 4 contained in the first opinion, are printed in the Appendix, *infra*, pp. 1a-39a.

Respondent opposed certiorari with respect to the Court of Appeals' first opinion on the ground that "At this stage of the proceeding, it has not yet been determined whether taxpayer is liable for Section 102 tax for the years in controversy" and, therefore, "There are no unusual circumstances calling for" the Supreme Court's "intervention prior to determination of the ultimate factual question by the courts below." Certiorari was denied and the case was returned to the Tax Court for further trial pursuant to mandate of the Court of Appeals.

JURISDICTION

The judgment of the Court of Appeals was entered in January 11, 1960 (App., *infra*, 40a). Petition for rehearing was filed on February 8, 1960 and was denied

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[2] Abbreviations used herein are as follows:

Vol. I, II, III—The certified transcript of record is in three volumes and will be referred to by the respective volume and page numbers.

R—Refers to record page before the Court of Appeals.

App., *infra*—Refers to the Appendix printed herein.

Stip.—Stipulated facts agreed upon by the parties.

by order of the Court of Appeals on February 24, 1960 (App., *infra*, 41a). The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTIONS PRESENTED

1. Whether replacement of exhausted facilities and mineral deposits constitutes a reasonable business need to be taken into consideration under the penalty surtax provisions of Section 102 of the Internal Revenue Code of 1939, or whether, as held below, such replacement requirements cannot be taken into consideration in determining reasonable business needs?

2. Whether the Court of Appeals, in direct conflict with decisions of this Court, erred in holding that petitioner was not entitled to accumulate any earnings to replace admittedly exhausted assets at any price, i.e., at either (a) the inflated cost prevailing during 1945-1950 or (b) the low prewar original cost reflected in petitioner's depreciation and depletion reserve accounts?

3. Whether the correct test, as held by the Second Circuit, for determining petitioner's need to accumulate earnings as a protective measure against imminent destruction of the business because of changed conditions should be based upon the honest belief of its officers during 1945-1950 rather than, as held below, upon what may now, on the basis of hindsight, appear to others to have been reasonable?

4. Whether the Court of Appeals, in direct conflict with decisions of this Court and other Courts of Appeals, erred in ignoring (a) the findings of the Tax Court Commissioner and the Tax Court and (b) the

documentary proof and testimony of ten eminently qualified witnesses, when throughout two lengthy trials respondent produced no witness to testify that petitioner accumulated earnings beyond the reasonable needs of its business?

5. Whether, although petitioner was clearly deprived of the statutory right to have its case (a) considered on the merits by the Secretary of the Treasury or his delegate and (b) tried and decided by the Tax Court with the burden of proof on respondent, the Court of Appeals erred, in violation of the August 11, 1955 amendment to Section 534 of the Internal Revenue Code of 1954, in "assuming" that such important substantive and procedural rights would have been of no avail to petitioner?

STATUTES, REGULATIONS AND SENATE FINANCE COMMITTEE REPORT INVOLVED

These are printed in the Appendix, *infra*, pp. 42a-48a.

STATEMENT

The ultimate issue is whether petitioner unreasonably accumulated earnings beyond the needs of its business in the years 1945 through 1950 and is, therefore, subject to Section 102 penalty surtax for those years.

This case was first tried before the Tax Court in 1954 and retried on the merits in 1958, pursuant to reversal and remand of the Court of Appeals.

To avoid confusion, it is pointed out that the findings of fact by the Tax Court Commissioner, which were adopted by the Tax Court as its findings, strongly support petitioner's position (Vol. I, 1a-40a). Therefore, petitioner relies upon the facts as found below

despite adverse decisions inconsistent and conflicting with the found facts. For example:

(1) The Tax Court found that petitioner's stipulated losses sustained through depreciation, depletion and bad debts were from $2,175,170.39 to $2,566,481.31, but, without any explanation for so doing, the Court overlooked those replacement needs in its opinion (Vol. I, 19-29). The Court of Appeals sought to justify this oversight on its newly stated theory that replacement of exhausted operating facilities, depleted mineral deposits, and bad debt losses cannot be taken into account in determining reasonable business needs (Vol. III, Petition for rehearing, pp. 1-7).

(2) The Tax Court found that petitioner's Federal income tax liabilities, not listed on its balance sheet, ranged up to $1,794,562.00, but without explanation failed to take into account any part of such liabilities in determining reasonable business needs (Vol. I, 19-29, 12a, 31a; Vol. III, Petition for rehearing, pp. 14-15). The Court of Appeals sought to justify this error on the basis of its mistaken belief that the $1,794,562.00 included income tax liabilities of other taxpayers (Vol. III, Petition for rehearing, pp. 14-15).

Petitioner began business in 1927 with assets of more than $7,365,179.85 (Vol. I, 1a, 19a; Stip. Ex. 14; R. 927-928). In 1927 petitioner's production facilities were in excellent operating condition and its supply of sand and gravel in up-river deposits close to distribution centers was ample (Vol. I, 24a, 25a, 27a; R. 240-241).

In 1945-1950 petitioner's up-river deposits were exhausted and its operating facilities were worn out (Vol. I, 24a, 25a, 27a). Petitioner's total assets com-

pared with its recorded liabilities and reserves, found below, as follows (Stip. Ex. 14; Vol. I, 12a, 14a, 17a, 31a, 34a, 39a-40a):

Year	Total Assets	Liabilities and Reserves	Deficits
1945	$7,003,917.83	$7,813,657.96	($ 809.740.13)
1946	7,240,879.10	8,365,270.33	(1.124.391.23)
1947	7,624,693.11	9,149,541.93	(1.524.848.82)
1948	7,858,778.29	9,516,556.31	(1.657.778.02)
1949	7,880,412.59	8,183,781.86	(303.369.27)
1950	8,271,879.53	8,435,649.78	(163.770.25)

The above deficits do not take into account petitioner's financial requirements for working capital or to restore its gravel inventory which became exhausted in 1944. Also, such deficits, as shown by the Tax Court's findings, are based on the assumption that in 1945-1950 petitioner could replace its exhausted operating facilities and depleted deposits at original low prewar cost and would not be required to pay the inflated cost prevailing in 1945-1950.

Petitioner's depreciation and depletion reserves, based upon original cost, ranged from $2,041,378.29 to $2,358,419.03 during 1945-1950 (Vol. I, 39a-40a). Admittedly, as found by the Tax Court, the 1945-1950 cost to cover depreciation and replacement of needed facilities was from $4,366,489.38 to $6,700,733.16 (Vol. I, 33a-34a)—not taking into account replacement of depleted deposits.

The Court of Appeals' first opinion held that the $4,366,489.38 to $6,700,733.16 for replacement of depreciable facilities could not be taken into consideration as a reasonable business need because those were the amounts required to replace at the inflated prices prevailing during 1945-1950 (App., *infra*, 7a-8a).

Petitioner feels that this holding is clearly erroneous and it was the principal ground upon which certiorari was requested with respect to the first opinion.

Failure to take into account the sky-rocketing inflation of the 1945-1950 period seems particularly unsound in view of the fact that as a result of inflation petitioner was far worse off economically—to the extent of nearly $2,000,000.00—at the end of 1950 than at the beginning of 1945, despite the fact that its earnings, less taxes paid, had been retained in the business and substantially expended for tugs, barges and other essential requirements. However, respondent opposed certiorari on the ground that there had then been no final determination as to petitioner's liability for Section 102 penalty surtax and certiorari was denied.

The second opinion of the Court of Appeals has now finally held that petitioner was not entitled to accumulate any earnings whatsoever to replace its admittedly exhausted assets at either the low prewar original cost or at the prices prevailing during 1945-1950 and, for that reason, has imposed penalty surtax (App., *infra*, 31a-33a).

When liquid assets only are taken into account, the reasonable business needs, as found by the Tax Court, including the necessity for replacing exhausted property, show that the 1945-1950 *deficits* in liquid assets *on the Tax Court's own basis*, ranged from $5,195,805.09 to $7,889,952.15 (Vol. III, Petition for Rehearing, pp. 15-18).

When total assets are taken into account and compared with total reasonable needs established by documentary proof and undisputed testimony of ten

eminently qualified witnesses, it is clear that the 1945-1950 *deficits* ranged from $11,276,341.66 to $17,207,940.39 (Vol. I, 8-11, 19-26).

Petitioner's 1945-1950 retained earnings not expended in the carrying on of its business lacked from $1,747,797.93 to $3,088,915.71 of being enough to pay its 1945-1950 indebtedness (Vol. II, 9-10). Petitioner's total retained earnings, *during its entire existence,* not expended in carrying on its business lacked from $280,425.59 to $1,529,175.03 of being enough to pay its liabilities in 1945-1950 (Vol. II, 9-10).

Petitioner emerged from World War II in a seriously weakened condition. In 1945-1950 it suffered an annual average decrease of over 700,000 cubic yards in production of sand and gravel (Vol. I, 25a). This, as found by the Tax Court, was because at "the close of World War II much of petitioner's production equipment was in a run down condition and badly in need of replacement" and because "the best of" petitioner's up-river "deposits, particularly the gravel deposits had been exhausted" (Vol. I, 25a, 27a). Also, as found by the Tax Court, petitioner's inventory of gravel had become exhausted in 1944 (Vol. I, 5a, 24a). The Tax Court found that because of its weakened condition, "In some instances customers' requirements had to be cut in half" during 1945-1950 (Vol. I, 27a-28a).

The threat of the ready-mixed concrete industry to petitioner's business in 1945-1950 was correctly found by the Tax Court Commissioner and the Tax Court as follows (Vol. I, 9a-10a, 28a-29a):

> "For a number of years the ready-mix concrete business has been developing rapidly both on a

national scale and in the Washington, D. C. area. It was firmly established by about 1940 and at the present time it constitutes the larger portion of the concrete business.

"* * * In the beginning the ready-mix business was operated independently of the sand and gravel business, such as petitioner's. However, many of the sand and gravel producers have themselves gone into the ready-mix business *in order to protect their market.* Also, many of the ready-mix concerns have gone into the sand and gravel business to obtain their supplies of material. The general trend has been toward a merger of the two branches of the industry.

"In the Washington, D. C. area, as well as in most other large construction areas, the ready-mix industry has become the dominant factor in the concrete market. Several of the large ready-mix concerns in the Washington, D. C. area have purchased some or all of their sand and gravel from the petitioner. As their business expanded, petitioner was unable to supply their demands for sand and gravel and they were forced to look to other sources. In the meantime, the ready-mix concerns began demanding certain price concessions and other concessions which petitioner was unable or unwilling to grant, and transferring as much of their business as possible to petitioner's competitors. *By 1945 this situation had reached the point where, in the opinion of petitioner's officers, it constituted a severe threat to petitioner's business. Petitioner was confronted with the alternative of going into the ready-mix business itself or losing the major portion of its sand and gravel market.* Petitioner had always favored the development of the ready-mix business as a separate industry from the sand and gravel business and had given substantial financial assistance to several of its ready-mix customers.

> "At one time when the strained relationship between petitioner and the ready-mix concerns approached a climax, petitioner made an estimate of the additional facilities and equipment that it would need to go into the ready-mix business itself, and engaged a 'stand-by' salesman to handle the order. A break with the ready-mix concerns was averted, however, and at the present time they are purchasing from 50 to 80 per cent of petitioner's production of sand and gravel." (Emphasis supplied)

Petitioner's market outlet for sand and gravel was controlled by the ready-mixed concrete industry in 1945-1950. Banks threatened to cut off customers' credit to force them to stop buying sand and gravel from petitioner, instigators seeking to take petitioner's business attempted to have Mr. Smoot indicted and petitioner dissolved under the anti-trust laws, and the ablest men in the industry testified that without protective funds to enter the ready-mixed concrete industry petitioner's market outlet would be cut off (Vol. I, 11a, 30a, 91a-98a; Vol. III, Petition for Rehearing, pp. 9-12). In the opinion of petitioner's officers, "During" the "1945 through 1950 period, the imminence of that threat was so great that we felt that the probability or the likelihood of The Smoot Sand & Gravel Corporation having to go into the ready-mixed concrete business was by far greater than the possibility that it might be able to stay out of it" (Vol. I, 75a-76a).

Undisputed testimony of independent experts shows that petitioner would have required from $7,286,743.10 in 1945 to $11,794,811.43 in 1950 to enter the ready-mixed concrete business (Vol. I, 92a-100a; Exs. 15, 16).

The Court of Appeals recognized that petitioner's "officers sincerely believed that it would be forced into the ready-mixed concrete industry" during 1945-1950 (App., *infra*, 25a). However, the Court of Appeals decided the issue against petitioner on the ground that the threat was avoided. The Court explained its position, on the basis of hindsight, as follows (App., *infra*, 27a):

> "It is undisputed that the corporation did not, voluntarily or involuntarily, enter" the ready-mixed concrete "business at any time."

The Court of Appeals seemingly does not doubt that petitioner's officers sincerely believed that it would be forced to enter the ready-mixed concrete business in 1945-1950. But, inasmuch as the threat has thus far been avoided, the Court of Appeals has held that it cannot be taken into account in determining petitioner's reasonable needs during 1945-1950.

Respondent made no investigation to determine whether petitioner had accumulated earnings beyond the reasonable needs of its business prior to sending the deficiency notices in this case and such notices were sent without even being read by any official authorized to determine deficiencies (R. 412-453, 787-831, 1129-1151).

Throughout two lengthy trials respondent has called no witness to testify that petitioner had accumulated earnings beyond the reasonable needs of its business during 1945-1950 or at any other time.

After an exhaustive investigation of petitioner's needs, the President of The American Appraisal Company testified that petitioner should not have paid

dividends during 1945-1950 because it "needed so badly" to replace its exhausted operating assets (R. 670). On the basis of documentary proof and testimony of ten outstandingly able witnesses the undisputed evidence shows that petitioner's reasonable needs during 1945-1950 ranged from $18,280,259.49 to $25,291,480.04 (Vol. I, 8-11).

REASONS FOR GRANTING THE WRIT

1. The Court of Appeals' Holding That Necessity for Replacing Exhausted Operating Facilities and Depleted Mineral Deposits Cannot be Taken Into Account in Determining Reasonable Business Needs Is Based Upon a Newly Enunciated Rule of Law to the Effect That Consideration of Such Admitted Replacement Needs Would Constitute Giving Taxpayers the Benefit of Unallowable "Double Deductions". This New Principle Was Not Mentioned in the Instant Litigation Until the Second Appeal and Has Never Heretofore Been Advanced in Any Other Case. The Principle Is Obviously Unsound and Is in Direct Conflict With the Decisions of This Court and All Other Authorities.

The Court of Appeals' first opinion held that petitioner was not entitled to retain earnings for the purpose of replacing exhausted assets at the inflated prices prevailing during the 1945-1950 period (App., *infra*, 7a-8a). Its second opinion now holds that petitioner is not entitled to recover from earnings the original low prewar cost for replacing exhausted assets on the ground that to take into consideration the necessity of replacement would constitute giving "the taxpayer double deductions" (App., *infra*, 31a-33a). Thus, petitioner is allowed nothing to replace exhausted assets under the newly enunciated "double deduction" theory.

In *Helvering* v. *National Grocery Co.*, 304 U.S. 282, 291, 82 L. Ed. 1346, 1354, this Court expressly held

that in penalty surtax cases "Depreciation in any of the assets" must be taken into account "in determining the issue of fact whether the accumulation of profits was in excess of the reasonable needs of the business."

In *Knoxville* v. *Knoxville Water Co.*, 212 U.S. 1, 13, 53 L. Ed. 371, 380, this Court stated:

> "* * * Before coming to the question of profit at all the company is entitled to earn a sufficient sum annually to provide not only for current repairs but for making good the depreciation and replacing the parts of the property when they come to the end of their life. The company is not bound to see its property gradually waste, without making provision out of earnings for its replacement. It is entitled to see that from earnings the value of the property invested is kept unimpaired, so that at the end of any given term of years the original investment remains as it was at the beginning. It is not only the right of the company to make such a provision, but it is its duty to its bond and stockholders, and, in the case of a public service corporation at least, its plain duty to the public. If a different course were pursued the only method of providing for replacement of property which has ceased to be useful would be the investment of new capital and the issue of new bonds or stocks."

In penalty surtax cases it has always been held that "reasonable accumulations" for "maintenance and replacements" are "recognized as factors excusing the corporation from the payment of dividends." Mertens, *Law of Federal Income Taxation*, Section 39.46. Prentice-Hall collates the authorities and correctly states that "in the case of a business corporation actually engaged in commercial operation, depreciа-

tion in any of the assets is evidence in determining whether an accumulation is in excess of the reasonable needs of the business" and points out that "sound business policy may require withholding from distribution liquid assets equal to the reserve for depreciation and for obsolescence." 1960 Prentice-Hall Federal Tax Service, page 4718. See also *United States* v. *Ludey*, 274 U.S. 295, 301, 71 L. Ed. 1054, 1058; *Detroit Edison Co.* v. *Commissioner*, 319 U.S. 98, 101, 87 L. Ed. 1286, 1289; and *Virginian Hotel Corporation of Lynchburg* v. *Helvering*, 319 U.S. 523, 528, 87 L. Ed. 1561, 1565.

In direct conflict with the decisions of this Court and all other authorities, on the decisive issue as to petitioner's right to replace its exhausted assets, the Court of Appeals has held that such replacement requirements cannot be taken into account in determining the reasonable needs of its business. Because the erroneous "double deduction" theory was never mentioned, in this or any other case, before the second appeal, petitioner had no opportunity to demonstrate its fallacy through the testimony of expert witnesses. Consequently, petitioner relied upon the affidavit of a Certified Public Accountant explaining why the taking into consideration of its replacement reserve accounts in determining reasonable needs does not constitute giving petitioner the benefit of any deduction or of "double deductions". See Vol. III, Petition for Rehearing, pp. 26-28. Such affidavit states, in part, as follows:

> "* * * In my opinion, the taking into consideration of the losses recorded by such reserve accounts would neither constitute 'double deductions' nor any deductions at all.

"Such reserve accounts record the corporation's losses of from $2,175,170.39 to $2,566,481.31 sustained through depreciation, depletion and bad debts. To the extent that the corporation has deducted such losses from gross income and retained equivalent funds, such funds are included in its total assets. The taking into consideration of the depreciation, depletion and bad debt reserves, recording the losses, to determine the amount needed, at original cost, to replace the assets so lost does not constitute any deduction from an accounting standpoint. On the contrary, such reserve accounts recording the losses merely show the reason why the corporation was allowed to deduct such losses from gross income and the purpose for which gross income equal to the losses deducted was retained. The reserve accounts only state the amount that must be utilized from the corporation's assets if its properties lost through depreciation, depletion and bad debts are to be replaced at the original cost of such lost properties. In other words, the corporation's depreciation, depletion and bad debt reserve accounts state on the face of the balance sheets the amount of assets required at the end of each year to replace, at original cost, the corporation's assets lost through depreciation, depletion and bad debts and, therefore, the consideration of the reserve accounts recording such losses does not involve deductions from an accounting standpoint."

The Court of Appeals has *included* as a part of petitioner's financial resources the amounts retained to replace its exhausted assets and, at the same time, has held that petitioner is not entitled to show the *very purpose* for which such retention was made. Under this Court's decisions, petitioner is clearly entitled to have its total assets, as found below, com-

pared with its total liabilities and reserves, as found below, in determining the reasonable needs of its business. The Court of Appeals disregarded all authorities, including this Court's opinions, and erred in refusing to make such a comparison. See Vol. III, Petition for Rehearing, pp. 1-7.

The consequences of the newly stated "double deduction" theory are serious and far reaching. The theory cumulatively *decreases* the amount taken into account for reasonable business needs to the extent that the need for replacement cumulatively *increases* each year. Under this erroneous principle, every corporation utilizing expensive facilities or mineral deposits will be subjected to penalty surtax, if it accumulates earnings to replace its wasting assets.[3]

Elimination of depreciation and depletion reserves from consideration in determining reasonable business needs will place taxpayers, as it does this petitioner, in a vicious circle. Each year those replacement reserves increase as petitioner's operating assets decrease through exhaustion. Under the Court of

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[3] The term "surplus" is an antiquated misnomer no longer used in modern accounting. "Its use in a balance sheet without a qualifying adjective is obsolescent." *A Dictionary for Accountants*, by Kohler (1953). This is because the unearmarked surplus reflects amounts retained for business needs. To illustrate, the General Motors Corporation's balance sheet shows depreciable assets, "Less accumulated depreciation and obsolescence" of $3,257,861,754.00, in stating its total assets of $7,271,136,285.00. General Motors designates its "surplus" of $4,057,240,838.00 as being "retained for use in the business (earned surplus)." Petitioner's recorded need for replacement, as shown by its reserve accounts of $2,041,378.29 to $2,372,846.99, should be allowed in determining reasonable needs just as General Motors' replacement reserves of $3,257,861,754.00 would have to be taken into account in determining that corporation's reasonable needs.

Appeals' holding, petitioner is each year increasingly and progressively deprived of its right to provide for replacement to the extent of the cumulatively increased amount of its loss through depreciation and depletion. Such a principle is unsound and is in direct conflict with the decisions of this Court and all other authorities.

The practical effect of the newly stated "double deduction" theory places corporations in a hopeless position for this reason: The amount of liquid assets retained to replace operating assets lost through depreciation and depletion during their useful lives necessarily increases each year, otherwise, the operating assets could not be replaced when fully exhausted. Under the Court of Appeals' newly stated principle, the purpose for which these liquid assets are retained cannot be considered a need of the business because, allegedly, this would constitute giving the taxpayer the benefit of unallowable "double deductions" (App., *infra*, 31a-33a). Thus, without being allowed to show the replacement purposes for which the liquid assets were retained, the corporation will necessarily be treated as having accumulated beyond its reasonable needs if needs other than replacement are provided for. Consequently, the imposition of the penalty surtax is no longer dependent upon reasonable business needs but, with the need for replacement of lost assets excluded, will necessarily be imposed upon amounts retained beyond only a part of business needs. Not only does the newly stated theory take into account only a part of business needs, but the theory actually *treats the amounts retained to replace lost assets as being available for those other partial business needs and thereby subjects amounts retained*

for replacement to penalty surtax. Thus, the effect of the erroneous newly stated principle is to subject to the penalty surtax amounts retained to offset and replace lost assets. The Supreme Court has flatly held that a corporation cannot be placed in any such untenable position. *Helvering* v. *National Grocery Co., supra,* and *Knoxville* v. *Knoxville Water Company, supra.*

The erroneous "double deduction" theory, prohibiting consideration of depreciation and depletion losses in determining reasonable business needs, can only lead to confusion throughout the country until corrected by this Court or the Congress. Petitioner respectfully asks that certiorari be granted in order that the seriously unsound principle may be corrected in the instant case.

2. In Conflict With the Second Circuit and All Other Authorities, the Court Below Has Held That Even Though Petitioner Honestly and Sincerely Believed That the Existence of Its Business Was Under Imminent Threat by the Ready-Mixed Concrete Industry in 1945-1950, Petitioner Was Not Entitled to Take Protective Measures Because, on the Basis of Hindsight, It Is Now Known That the Threat Was Avoided.

Circuit Judge Hand in *Casey* v. *Commissioner,* 276 F. 2d 26, 3 AFTR 2d 1440 (CA 2, 1959), has succinctly and correctly stated the principle applicable, as follows:

> "* * * I believe that the statute meant to set up as a test of 'reasonable needs,' only the corporation's honest belief that the existing accumulation was no greater than was reasonably necessary."

There can be no doubt that petitioner honestly and sincerely believed in 1945-1950 that the existence of its business was imminently threatened by the ready-mixed concrete industry (Vol. I, 9a-10a, 28a-29a, 75a-79a, 87a-88a, 91a-98a, 101a-103a, 107a-109a, 114a-118a; Vol. III, Petition for Rehearing, pp. 8-13). This threat was found by the Tax Court Commissioner and the Tax Court to be as follows (Vol. I, 9a-10a, 28a-29a):

> **"* * * By 1945 this situation had reached the point where, in the opinion of petitioner's officers, it constituted a severe threat to petitioner's business. Petitioner was confronted with the alternative of going into the ready-mix business itself or losing the major portion of its sand and gravel market."**

Nevertheless, the Court below has substituted its hindsight "reasonably believed" test for the correct current "honest belief" test and held that petitioner was not entitled to take protective measures against the imminent threat as found by the Tax Court. The Court, on the basis of many years' hindsight, has held that its "reasonably believed" test is not met because now "It is undisputed that the corporation did not, voluntarily or involuntarily enter" the ready-mixed concrete "business at any time" (App., *infra*, 27a). This is based solely on hindsight in 1960 and certainly could not have been known to petitioner's officers in 1945-1950 when they believed that "the probability or the likelihood of" petitioner "having to go into the ready-mixed concrete business was by far greater than the possibility that it might be able to stay out of it" (Vol. I, 75a-76a).

Undisputed testimony of the ablest *independent* witnesses in the country shows that petitioner's financial requirements to protect itself against the threat of the ready-mixed concrete industry materially exceeded its total assets during the entire 1945-1950 period (Vol. I, 92a-100a; Exs. 15, 16).

The hindsight rule is in direct conflict with the principles applied by the Second Circuit in *Casey* v. *Commissioner, supra.* In that case the Second Circuit explicitly stated that *"Congress did not want the taxing authorities to be second-guessing the responsible managers of corporations as to whether and to what extent profits should be distributed or retained"* and explained that the right to impose penalty surtax *"is not satisfied by proving that the corporation was mistaken as to its estimate of its future 'needs'."*

The vice of the erroneous hindsight principle on which the Court below has relied is that every precautionary measure honestly taken by a corporation against fire, hurricane, public liability, ruthless competition, or other hazards will be ruled out of consideration in determining reasonable business needs unless disaster occurs. This confronts corporations with the dilemma (a) of being destroyed by penalty surtax if they honestly take precautionary measures against hazards which do not occur or (b) of being destroyed by casualty if such protective measures are not taken and the hazards do occur. The hindsight rule, in conflict with all authorities, is unsound on reason and principle and constitutes an important question of Federal law which should be settled by this Court. See *Casey* v. *Commissioner, supra;*

Mertens, *Law of Federal Income Taxation*, Sections 39.42, 39.44.

The correct principle enunciated by the Second Circuit, based upon the corporation's honest belief during the period involved, should be uniformly applied and the seriously erroneous hindsight principle should be repudiated.

3. When the Tax Court's Own Specific Findings Are Taken Into Consideration and Added Up the Result Is, on the Tax Court's Own Basis, That Petitioner Had Accumulated Earnings Deficits of From $756,275.25 to $2,307,778.02 in 1945-1950. It Is Only on the Basis of Overlooking the Tax Court's Own Specific Findings as to Replacement Needs and Income Tax Liabilities That Any Different Result Could Be Reached. When the Documentary Proof and Undisputed Testimony, Not Rebutted in Any Manner, of Ten Eminently Qualified Witnesses Are Taken Into Account It Is Clear That Petitioner's Actual Accumulated Earnings Deficits in 1945-1950 Ranged From $11,276,341.66 to $17,207,940.39. In Direct Conflict With the Decisions of This Court and Other Courts of Appeals the Court Below Has Failed to Decide the Instant Case on the Basis of Either the Facts as Specifically Found by the Tax Court or the Undisputed Proof.

The findings of fact by the Tax Court Commissioner, which were adopted by the Tax Court, support petitioner's position (Vol. I, 1a-40a). When the reasonable business needs, *as found by the Tax Court*, are totaled the result is as follows (Vol. I, 19-28, 12a, 14a, 17a, 31a, 34a, 39a-40a):

	12/31/45	12/31/46	12/31/47
Reserves and Liabilities per books and records	$7,813,657.96	$8,365,270.33	$9,149,541.93
Total Assets	7,003,917.83	7,240,879.10	7,624,693.11
Surplus Deficit	($ 809.740.13)	($1,124.391.23)	($1.524.848.82)
Add:			
Loans to customers	72,917.00		135,000.00
Working capital	500,000.00	500,000.00	500,000.00
Accumulated Earnings Deficit	($1.382.657.13)	($1.624.391.23)	($2.159.848.82)

	12/31/48	12/31/49	12/31/50
Reserves and Liabilities per books and records	$9,516,556.31	$8,183,781.86	$8,435,649.78
Total Assets	7,858,778.29	7,880,412.59	8,271,879.53
Surplus Deficit	($1.657,778.02)	($ 303.369.27)	($ 163.770.25)
Add:			
Loans to customers	150,000.00		92,505.00
Working capital	500,000.00	500,000.00	500,000.00
Accumulated Earnings Deficit	($2.307,778.02)	($ 803.369.27)	($ 756.275.25)

It is solely by ignoring the specifically found replacement needs based on low prewar cost and the specifically found income tax liabilities that either Court below could reach the clearly erroneous crucial holding that petitioner had accumulated earnings beyond the reasonable needs of its business. See Vol. I, 19-26; Vol. III, Petition for Rehearing, pp. 1-8, 14-21.

Respondent failed to call any witness to testify on the merits in this case or to state that petitioner had accumulated earnings beyond the reasonable needs of its business. On the basis of documentary proof and unimpeached testimony of ten witnesses the result is that petitioner's total assets compared with its conclusively established reasonable needs as follows:

Year	Total Assets	Proven Reasonable Needs	Accumulated Earnings Deficits
1945	$7,003,917.83	$18,280,259.49	($11,276,341.66)
1946	7,240,879.10	20,422,503.59	(13,181,624.49)
1947	7,624,693.11	23,347,239.63	(15,722,546.52)
1948	7,858,778.29	25,066,718.68	(17,207,940.39)
1949	7,880,412.59	24,203,644.03	(16,323,231.44)
1950	8,271,879.53	25,291,480.04	(17,019,600.51)

The Court of Appeals' failure to decide the instant case either on the basis of the amount of reasonable business needs found by the Tax Court, but then disregarded, or, on the basis of much larger reasonable business needs, conclusively established by undisputed proof, is in direct conflict with the decisions of this Court and of other Courts of Appeals. *Montana Ry. Co.* v. *Warren*, 137 U.S. 348, 34 L. Ed. 681; *New York Life Insurance Company* v. *Gamer*, 303 U.S. 161, 82 L. Ed. 726; *Henderson* v. *Richardson Co.*, 25 F. 2d 225 (CA 4); *Wilson* v. *Williams Hardware Co.*, 32 F. 2d 103 (CA 4); *Ariasi* v. *Orient Ins. Co.*, 50 F. 2d 548 (CA 9); *Austerberry* v. *United States*, 169 F. 2d 583 (CA 6); *Blackmer* v. *Commissioner*, 70 F. 2d 255, 13 AFTR 957 (CA 2); *Belridge Oil Co.* v. *Commissioner*, 85 F. 2d 762, 18 AFTR 512 (CA 9); *Nichols* v. *Commissioner*, 44 F. 2d 157, 9 AFTR 285 (CA 3); *J. H. Robinson Truck Lines, Inc.* v. *Commissioner*, 183 F. 2d 734, 39 AFTR 788 (CA 5); *Boggs & Buhl* v. *Commissioner*, 34 F. 2d 859, 8 AFTR 9631 (CA 3); *Loesch & Green Const. Co.* v. *Commissioner*, 211 F. 2d 210, 45 AFTR 458 (CA 6).

The "*tendency of the Tax Court to ignore plain, uncontroverted testimony, and to reach for facts contrary to the testimony without there being any basis in fact for so doing*" was expressly pointed out

by the Sixth Circuit in the recent case of *Tank* v. *Commissioner*, 270 F. 2d 477, 486, 4 AFTR 2d 5495, 5504 (1959). Also, in the recent case of *Gordon* v. *Commissioner*, 268 F. 2d 105, 107, 4 AFTR 2d 5044, 5046 (1959), the Third Circuit found it necessary to reverse the Tax Court because *"the Tax Court arbitrarily disregarded unchallenged, competent and relevant evidence in the record which was inherently credible"*. The errors are far more glaring in the instant case than those judicially recognized in *Tank* v. *Commissioner*, *supra*, and *Gordon* v. *Commissioner*, *supra*.

The manifest failure to decide this case on the basis of either the findings of fact or undisputed proof, in direct conflict with the decisions of this Court and other Courts of Appeals, particularly invites consideration by the Supreme Court.

4. Under the August 11, 1955 Amendment to Section 534 of the Internal Revenue Code of 1954, Petitioner Was Entitled to Have Its Case (a) Considered on the Merits by the Secretary of the Treasury or His Delegate and (b) Tried and Decided by the Tax Court With the Burden of Proof on Respondent. Nevertheless, in Direct Violation of Section 534, as Amended, on the Basis of "Assuming" That Such Important Substantive and Procedural Rights Would Have Been of No Avail to Petitioner, the Court of Appeals Affirmed Despite the Fact That Petitioner Had Been Deprived of Consideration on the Merits by the Secretary or His Delegate and of Trial and Decision by the Tax Court With the Burden of Proof on Respondent.

Under the August 11, 1955 amendment to Section 534 of the Internal Revenue Code of 1954, petitioner was clearly entitled to have its case considered on the merits by the Secretary of the Treasury or his delegate and, if the decision on the merits was unfavorable, petitioner was entitled to have its case tried

in 1958 and decided by the Tax Court with the burden of proof on respondent. See 1954 I.R.C. Sections 534 (b), (c) and (e); Regulations (T.D. 6377, filed 5-12-59) Section 1.534-4; and Senate Finance Committee Report printed in the Appendix, *infra*, at pages 44a-48a. See also *Casey* v. *Commissioner*, *supra*; Mertens, *Law of Federal Income Taxation*, Section 39.30; Vol. I, 41-48; Vol. II, 12-16; and Vol. III, Petition for Rehearing, pp. 21-25. Despite the fact that petitioner was deprived of both of these important statutory rights, the Court of Appeals has affirmed the Tax Court on the "assumption" that such rights would not have benefited petitioner (App., *infra*, p. 37a).

The importance of the August 11, 1955 amendment was clearly stated by the Second Circuit in *Casey* v. *Commissioner*, *supra*, as follows:

> "Prior to the enactment of certain statutes which we will now advert to, a determination by the Commissioner of Internal Revenue that a corporation had allowed its earnings or profits to accumulate beyond the reasonable needs of the business would have carried a presumption of its own correctness, and the taxpayer would have had the burden of rebutting that presumption. Section 534 of the Internal Revenue Code of 1954, in its paragraphs (a)(2) and (c), provides that in circumstances present in the instant case the Commissioner should have the burden of proving the fact of the asserted unreasonable accumulation. And by the Act of August 11, 1955, c. 805, 69 Stat. 689, 690, section 4, the above provision of the 1954 Code was amended to make it *retroactive and applicable 'in the case of proceedings tried on the merits after the date of the enactment of this paragraph.'* The 1955 amendment is applicable to the instant case.

"The Commissioner of Internal Revenue then had the burden of proof that Bankers had unreasonable accumulated profits. *We think that the 1954 and 1955 enactments indicate that Congress did not want the taxing authorities to be second-guessing the responsible mgnagers of corporations as to whether and to what extent profits should be distributed or retained, unless the taxing authorities were in a position to prove that their position was correct. This recent expression of Congress should, perhaps, have some bearing upon our approach to our review of the Tax Court's decision.*

* * * * *

"* * * I believe that the statute meant to set up as a test of 'reasonable needs,' only the corporation's honest belief that the existing accumulation was no greater than was reasonably necessary. Section 532(a) was a penal statute, designed to defeat any plan to evade the shareholders' taxes, and there can be *no doubt that it presupposes some deliberate purpose to do so and is not satisfied by proving that the corporation was mistaken in its estimate of its future 'needs.'*" (Emphasis supplied)

The wholly unfair treatment to which petitioner has been subjected is unmistakable: Respondent, by his omission in not sending the requisite notification, deprived petitioner of its right to review by the Secretary or his delegate and the burden of proof clearly should have been upon respondent. Nevertheless, by the Tax Court's error, petitioner has been deprived of trial and decision with the burden of proof on respondent and, instead, has been subjected to the disadvantage of trial and decision with the burden of proof on petitioner (Vol. I, 44-47; Vol. II, 12-16; Vol. III, Petition for Rehearing, pp. 21-25).

By contrast, the Second Circuit's eminently fair and proper treatment accorded the taxpayer, pursuant to provisions of the August 11, 1955 amendment, in *Casey* v. *Commissioner, supra,* emphatically illustrates the inexcusably unfair treatment to which petitioner has been subjected below in violation of its clear and important legal rights. The direct conflict between the two Courts of Appeals involves basic statutory rights of the greatest importance to taxpayers.

On this record, there is no basis for assuming that the Secretary or his delegate would have decided against petitioner or that the majority of the Tax Court would have decided against petitioner had the burden of proof been properly placed upon respondent for trial and decision below. Thus, it is clear that petitioner's rights, both substantive and procedural, have been violated to its serious detriment and that such important rights cannot properly be "assumed" away.

The statutory right to review by the Secretary or his delegate was of vital importance to petitioner because the record clearly shows (a) that its case was never considered on the merits by the Secretary or his delegate, (b) that actually the deficiency notices were sent to petitioner without any investigation or knowledge on respondent's part as to the reasonable needs of the business, and (c) that deficiency notices were sent without even being read by any official authorized to determine deficiencies (R. 412-453, 787-831, 1129-1151). The statutory right to trial with the burden of proof on respondent was equally important to petitioner.

It is respectfully submitted that petitioner's important statutory rights, *specifically provided by*

Section 534, as amended, entitling it to review on the merits by the Secretary or his delegate and to trial and decision with respondent having the burden of proof, cannot properly be denied by the Court of Appeals' "assumption" as to (a) what the result might have been had petitioner been granted the review on the merits to which it was entitled or (b) what the decision of the full Tax Court would have been had the case been tried and decided with the burden of proof on respondent.

Petitioner respectfully maintains that the Tax Court and the Court of Appeals are without authority to ignore the clear and important statutory rights expressly granted to petitioner by Congress in the August 11, 1955 amendment to Section 534 of the Internal Revenue Code of 1954. See Section 534, as amended, the respondent's own Regulations, and the pertinent Senate Finance Committee Report set forth in the Appendix, *infra,* at pages 44a-48a. The Court of Appeals' "assumption" that had those basic rights been granted they would have been of no avail to petitioner is in direct violation of Section 534, as amended, and in violation of due process of law. In this case such an assumption is neither legally nor factually warranted and, in any event, the deprival of such important statutory rights, specifically granted by Congress, on the basis of assumption involves an important question of Federal law that should be considered by this Court.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that this petition for a writ of certiorari should be granted.

Respectfully submitted,

DAVID R. SHELTON
Munsey Building
Washington 4, D. C.

April, 1960.

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APPENDIX

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 7265

THE SMOOT SAND & GRAVEL CORPORATION, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

ON PETITION TO REVIEW THE DECISIONS OF
THE TAX COURT OF THE UNITED STATES.

(Argued October 17, 1956. Decided January 16, 1957.)

Before SOPER, FAHY, and SOBELOFF, Circuit Judges.

David R. Shelton for Petitioner, and David O. Walter, Attorney, Department of Justice, (Charles K. Rice, Assistant Attorney General, Lee A. Jackson and A. F. Prescott, Attorneys, Department of Justice, on brief) for Respondent.

SOBELOFF, Circuit Judge:

This is a petition for review of a decision of the Tax Court of the United States upholding an assessment made by the Commissioner of Internal Revenue against the Petitioner, the Smoot Sand and Gravel Corporation, for surtaxes under Section 102 (a) of the Internal Revenue Code

of 1939.[1] Liability rests upon the finding that the corporation was availed of in the years 1945-1950 for the purpose of preventing the imposition of surtax upon its sole stockholder, Columbia Sand and Gravel Company, Inc., and upon L. E. Smoot, owner of all the common stock of the latter company.

Despite high earnings, petitioner declared no dividend during the period 1945-1950 and, in fact, has declared none since 1932. The statute makes accumulation beyond reasonable needs determinative of the prohibited purpose (to prevent imposition of surtax) "unless the corporation by the clear preponderance of the evidence shall prove to the contrary." Sec. 102 (c). The Commissioner found that the corporation did permit the earnings and profits of the petitioner to accumulate beyond the reasonable needs of the business, instead of being divided or distributed, and assessed tax liability for the years in question as follows:

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[1] Section 102, Surtax on Corporations Improperly Accumulating Surplus. (a) *Imposition of Tax.* There shall be levied, collected, and paid for each taxable year (in addition to other taxes imposed by this chapter) upon the net income of every corporation (other than a personal holding company as defined in section 501 or a foreign personal holding company as defined in Supplement P) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

27½ per centum of the amount of the undistributed section 102 net income not in excess of $100,000.00, plus

38½ per centum of the undistributed section 102 net income in excess of $100,000.00.

Year	Alleged Sec. 102 Net Income	Alleged Sec. 102 Surtax
1945	$ 208,223.94	$ 69,166.22
1946	237,476.03	80,428.27
1947	356,230.82	126,148.87
1948	319,777.10	112,114.18
1949	96,211.21	26,458.08
1950	124,915.35	37,092.41
	$1,342,834.45	$451,408.03

It is the petitioner's contention that the accumulation of earnings during the taxable years was justified to meet actual or potential needs of the business and that the needs were in fact even greater than its combined surplus and reserves for contingencies. These conflicting contentions present the central issue.

The petitioner's testimony took a wide range, bringing into review various phases of the petitioner's business, its history, its policies, its problems, and its plans. The Commissioner concedes that if dividends were withheld in order to maintain reserves not in excess of the reasonable needs of the business, then the penalties of Section 102 do not apply. On an issue that is essentially factual, the scope of our review is limited to determining whether there is substantial evidence to support the findings of the Tax Court (*Helvering* vs. *National Grocery Company*, 304 U.S. 282; *Helvering* vs. *Stock Yards Company*, 318 U.S. 693; *W. H. Gunlocke Chain Company* vs. *Commissioner*, Cir. 2, 145 Fed. (2d) 791) and whether the law was correctly applied.

It is not feasible nor would it be useful to repeat in detail the facts which have been fully set forth in the findings and opinion of the Tax Court, but as we proceed, we shall outline the evidence sufficiently to indicate the points in controversy.

The Smoot Sand and Gravel Corporation is engaged in the mining, dredging, and processing of sand and gravel in the District of Columbia, having been organized by L. E. Smoot in 1927 to take over the business begun by him more than a half century ago. The company enjoys a prominent position in the industry, having furnished materials for many of the large public and private construction jobs in the District of Columbia."

As shown in the above table, the five-year accumulation of earnings alleged to be beyond the reasonable needs of this business amounted to $1,342,834.45. On December 31, 1944, the beginning of the period under consideration, and on December 31, 1950, the end of the period, petitioner's books showed the following schedules of reserves for contingencies:[2]

---

[2] The word "reserves" as used in legal and accounting documents is capable of different meanings. The word is used variously to indicate: (1) a fund of cash actually set aside to meet a designated purpose; (2) estimated valuations of assets at less than their book values, such as (a) reserves for bad debts (made in valuing accounts receivable), or (b) reserves for depreciation (set up in estimating reduction in value of depreciable assets); (3) estimated liabilities; or (4) earmarking surplus for certain corporate purposes, to show that the sum is not available for dividends until the purpose for which the reserve is created has been met. It was in this last sense that the word was used by petitioner when it created the schedule of reserves for contingencies.

Reserve for:	Dec. 31, 1944	Dec. 31, 1950
Accrued bond interest	$ 615,203.29	836,783.29
Contract bonds	250,000.00	250,000.00
Workmen's insurance	150,000.00	200,000.00
Public liability	100,000.00	200,000.00
Fire and tornado insurance	250,000.00	250,000.00
Sand and gravel replacement	100,000.00	100,000.00
Concrete mixing equipment	500,000.00	500,000.00
Columbia Company good will	293,521.65	293,521.65
1941 income tax	3,974.25	.....
1942 income tax	16,663.61	.....
New Southeast plant	500,000.00	500,000.00
Postwar rehabilitation	1,333,000.00	1,333,000.00
Postwar credit	26,134.38	.....
Federal income tax, 1944	109,112.96	.....
D. C. income tax	10,846.38	19,608.22
Replacement sand and gravel	2,578.05	.....
Total	$4,261,034.57	$4,482,913.16[3]

During this period, however, the petitioner had on hand a large surplus over and above the amounts which it had as reserves. At the beginning of 1945, the total of the reserves and surplus amounted to $6,197,061.88, and at the close of 1950 it had grown to $7,646,805.92. In considering the company's fiscal needs and determining the reasonableness of its accumulation of earnings, it is, of course, necessary to take into account the capital resources it had from time to time in addition to its reserves.

I.

In 1953, primarily for the purposes of this suit, petitioner, with the aid of the American Appraisal Company, made a reappraisal of its financial needs, repudiating and abandoning as inadequate the schedules theretofore appear-

[3] The taxpayer does not agree to the accuracy of the above figures for 1950, which are taken from the Court's findings. Taxpayer claims that the correct figure is $4,738,102.32, a difference of $255,189.16. The original exhibit (Petitioner's Exhibit 14) gives a total in accord with petitioner's claim. However, the figure there appears to result from error in adding the items.

ing on its books. Throughout these proceedings, petitioner has sought to justify the accumulation of earnings on the basis of this reappraisal, which purports to show that petitioner's true financial needs in 1945 were $13,662,573.11 and gradually increased to $15,809,513.33 by 1950.[4]

A large part of this reappraisal consists of allotments for future replacement of various assets used by petitioner in mining and processing sand and gravel, and for expansion of plants and equipment used in the business. Petitioner owns three plants and uses large and expensive machinery and equipment in its operations. During World War II the company was particularly active to the point of strain upon its facilities and claims that reserves were therefore required for rehabilitation. It cannot be disputed that corporate reserves may properly take such objectives into account. But formal entries upon the books do not alone substantiate such needs, nor is justification for such reserves to be found merely in subsequently declared intentions. The intention claimed must be manifested by some contemporaneous course of conduct directed toward the claimed purpose. *KOMA, Inc.* vs. *Commissioner*, Cir. 10, 189 Fed. 2d 390; *Bride* vs. *Commissioner*, Cir. 8, 224 Fed. 2d 39. Here the petitioner failed to show that it had during the period 1945-1950 any definite plan for future replacement and expansion out of reserves.

The petitioner complains that the Tax Court improperly ignored the entire testimony of petitioner's witnesses re-

[4] These figures are from the petitioner's brief; but in the Tax Court, petitioner quoted them as $12,939,406.38 and $15,293,233.16; and the Tax Court uses round figures as "over $13,500,000.00, and $15,500,000.00." The petitioner's brief and appendix abound in such discrepancies. The diffuseness of the record, the absence of adequate references thereto, and the necessity of following through the references to a series of petitioner's briefs, arguments, and proposed findings which were offered in the Tax Court and included in the record here, but none of which documents is the original source, have made more difficult the perception and appraisal of petitioner's contentions.

garding the evaluation of sums needed for rehabilitation, even though the Government presented no evidence to rebut these estimates. In this respect, however, the petitioner labors under an obvious misconception. Basically the Tax Court did not undertake to dispute the petitioner's evidence as to the amounts needed for replacement and expansion. These estimates may, indeed, have been correct. Rather, the Court's decision relied upon the fact that these alleged needs were not the considerations upon which petitioner's accumulations of earnings were made. In order to determine whether profits were accumulated for the reasonable needs of the business or to avoid the surtax upon shareholders, the controlling intention of the taxpayer is that which is manifested at the time of the accumulation, not subsequently declared intentions which are merely the products of afterthought. *KOMA* vs. *Commissioner*, supra; *Bride* vs. *Commissioner*, supra.

II.

The issue of inflation was vigorously argued before us. Although the evidence shows that petitioner did not formulate or initiate any program for expansion or substantial replacement during the period 1945-1950, it seeks to excuse such omission by saying that the progressive inflation of those years made such investment inadvisable, inasmuch as it was awaiting "the usual post-war deflation." Despite this explanation, the petitioner nevertheless insists that in computing its capital requirements, the inflation in prices which occurred during the period should be considered. The Tax Court, says the petitioner, committed error in failing to consider this factor. 'A large part of the record is devoted to the issue of economic trends, but we think the entire discussion irrelevant to this case. There is a basic inconsistency in the petitioner's position, for if petitioner expected deflation, and for that reason deferred making investments, then assuredly its reserves reasonably could not have taken into consideration the factor

of inflation. In effect, its contention is that although it was awaiting deflation before investing, it is entitled to have its reasonable needs computed, after the event, in an amount sufficient to meet inflationary increases in cost which were not anticipated even as a possibility when the reserves in question were created. Logically, its intentions in withholding distribution of earnings had to be based on one theory or the other; we think they could not rest on both. The taxpayer could not justify its failure to use the reserve on the ground that it expected prices to decline, and yet, in computing its capital requirements, ask us to measure them, not as it measured them at the time, but in the light of the subsequent inflationary rise in costs. We do not mean to intimate that inflationary economic trends may never be considered in calculating future corporate needs, and we are not called upon in this case to pass upon such a question. That the petitioner never considered such a factor in determining its needs and, indeed, anticipated just the opposite, is sufficient reason to uphold the Tax Court's failure to consider this contention.

III.

We are in agreement with the findings of the Tax Court regarding a certain other group of allocations of reserves, as these findings are supported by substantial evidence. These are the reserves for self-insurance, for contract bonds, and for the corporate bond indebtedness.

Since petitioner was a self-insurer, it allocated, in its schedule of reserves, amounts thought reasonably necessary to cover possible losses in respect to workmen's insurance, public liability, and tornado and fire damage, totaling $500,000.00 at the end of 1944, and $650,000.00 at the end of 1950. There can be no doubt that reserves for such contingencies are proper. While saving the premiums it would otherwise have had to pay, the petitioner assumed a direct liability in an undetermined amount, and

the reserve was an estimate of this contingent liability. If petitioner wished to prove that the amounts needed for those purposes were larger than its own books indicated, then as the Tax Court pointed out, it should have produced actuarial evidence to support its contention. Inasmuch as petitioner failed to do so, it was certainly not unreasonable for the Tax Court to hold that the petitioner should be held to the amounts which it had set up on its books and which reflected what petitioner currently conceived to be its potential liability in these areas. Indeed, there is an absence of substantial evidence in the record to support a finding that larger amounts were required.

In the Tax Court's opinion and in the arguments made by the parties in this Court, there was considerable discussion concerning the fact that such losses as occurred were met out of current income without charging the contingent reserves which had been set up. The Commissioner apparently suggests the inference that the reserve was, therefore, unnecessary. This seems to us not to follow. When a contingency reserve is established for a single, specific purpose (for example, to anticipate an adverse judgment in a pending law suit), clearly, should the judgment be recovered against the taxpayer and satisfied out of current operating expenses, the need for the reserve would cease. However, where a reserve is established against a continuing hazard, the fact that losses as they occur are satisfied out of current earnings does not necessarily require the abandonment or reduction of the reserve in that amount. On the contrary, the circumstances may justify increased reserves, if experience indicates that initial estimates are inadequate; and similarly, they may require a reduction of reserves for the opposite reason. Consequently, we conclude that charging such expenditures to operating expenses, without reducing the reserve, is not a condemning fact. We uphold the Tax Court's conclusion disallowing additional reserves for self insurance on the ground that the petitioner failed to present proper evidence

to indicate the need for reserves larger than appeared on its books.

Another item included in the schedule of contingent reserves was for "contract bonds." This reserve petitioner set up because it did not obtain performance bonds with respect to any of its job contracts. When a contractor engages to perform work, he is usually required to furnish a performance bond, but petitioner's business reputation was such that it was not called upon to furnish bond. Accordingly, it undertook to set up a reserve of $250,000.00. It is not clear against what contingency this reserve was provided. The fact that no bonding company guaranteed petitioner's performance did not increase the latter's liability which as contractor it would have had if bond had been furnished. The principal remains liable for the performance of his contract whether or not a bond has been furnished, and if the surety is called upon to make good a default the principal is liable to the surety. The contingency against which the petitioner ostensibly sought protection by means of a reserve was the kind of liability that every contractor has, in any event, for the performance of his contract. For this reserve, therefore, no justification appears.

Included in the schedule of contingent reserves in the company's books was an allocation for accrued bond interest, and petitioner claims that its reserves should include this as a financial need as well as the principal debt upon which the interest was calculated. Actually, the original schedule of reserves did not include the principal bond debt. The petitioner says, however, that the Tax Court has recognized but failed to give effect to it as a proper item of reserve. We do not read the Court's opinion as recognizing the propriety of a reserve for the bond principal and interest, nor could we agree that the evidence would have supported such a finding. The petitioner argued to the Tax Court the double contention, first that dividends

were out of the question because bond indebtedness exceeded net income for each of the years in question, and second that were it not for petitioner's poor financial situation, earnings would have been utilized to discharge the bond debt and not to pay dividends.

The Court properly rejected the first contention, pointing out that in a Section 102 inquiry, the proper test was a comparison of surplus with the reasonable needs of the business to determine the propriety of further accumulation of earnings, and not a comparison of the earnings in any one year with the outstanding corporate obligations. Regarding the second contention, the Court pointed out that petitioner's original capitalization consisted of $15,000.00 of capital stock and $3,000,000.00 in bonds owed to L. E. Smoot, a ratio of one to two-hundred, and that this ratio had been attacked in previous years by the Commissioner as a "thin capitalization," whereby the Commissioner sought to treat the bonds as capital stock and the interest as a dividend not deductible by petitioner. Though the cases were compromised and never adjudicated, the Tax Court here thought, in the light of these facts, that the petitioner's failure to discharge the bond debt was due not to any financial predicament of the petitioner, as claimed, but to its purpose to withhold payments in discharge of the debt for fear of again encountering an attempt on the Commissioner's part to treat such interest payments and reduction of bond principal as dividends. Furthermore, it was noted, payments could be postponed indefinitely at Mr. Smoot's discretion. In these circumstances, it is difficult to perceive any justification for creating a reserve for the bond indebtedness.

IV.

Both in the original schedule for reserves and in the subsequent 1953 reappraisal of needs, figures were set out representing the estimated cost of entering into the

ready-mix concrete business. The ready-mix concrete business had become the major part of the cement industry in Washington, as well as in the rest of the nation, and a large portion of the sand and gravel sales made by the petitioner was to ready-mix customers. Because of the powerful position attained by the ready-mix concerns, they had the ability to demand price concessions from producers such as petitioner by threatening to enter into competition with them in the sand and gravel business. The petitioner says that, therefore, throughout the five-year period under examination, the ready-mix industry presented a continuing threat to it, and that it became strategically important, in order to withstand the pressure from these customers, for the petitioner to be financially prepared at all times to enter the ready-mix business. The further argument is that it was important to the petitioner that its ready-mix customers should know that if unduly pressed for price concessions and threatened with competition in the sand and gravel business, petitioner might respond by entering into competition with its ready-mix customers. This had the practical effect of offsetting the threats and demands of those customers. Therefore, petitioner's financial needs in each of the five years, as estimated in the 1953 appraisal, included $5,500,000.00 against the contingency of its entering into the ready-mix concrete business. This large figure was computed for the trial; the company's books for 1945-1950 showed only a contingent reserve of $500,000.00 for this item.

The Tax Court, refusing to recognize that a reserve for such need was reasonable, stated that "petitioner never planned or intended to go into the ready-mix business of its own free will, and the contingency which might have forced it to do so never developed." We think this was an improper way to dispose of the issue and that the reason assigned is not responsive to the claim asserted by the petitioner. If it was reasonable to anticipate a need for the petitioner to expand its business operations into the

ready-mix field, it is immaterial that such expansion would not be voluntary. Nor is it a conclusive answer that the contingency never, in fact, arose to force petitioner to enter this new business area. These circumstances do not reach the issue. What is material is whether or not petitioner reasonably believed that it might be forced into the ready-mix business as a defensive measure, and whether it reasonably intended to enter such business when and if the imminence of the threat should demand it. The fact that such a step would be taken involuntarily would not make the need less compelling. If the petitioner reasonably feared the contingency it had the right to protect itself by providing a reserve for this purpose.

If an inquiry addressed to this point in the light of the foregoing discussion were resolved in favor of the petitioner the Court would then have to determine the sum which petitioner at the time believed necessary to effectuate the purpose, though obviously the Court need not have accepted petitioner's estimate of $5,500,000.00. Acceptance of the petitioner's estimate, or a figure approaching this amount, for all or for a portion of the years in question, would have substantially affected the petitioner's financial requirements and the Section 102 surtax.

The Court might have disagreed with the Petitioner that it had reasonable ground to feel such a threat, or it may well be that the threat disappeared and was reduced merely to a remote possibility. If so, then from that time forward, the continued maintenance of the reserve would not have been proper. But we cannot determine from the Tax Court's findings whether this is what occurred, for no findings were made on these specific points. There are statements in the record that petitioner at one time had engaged a stand-by salesman to handle orders for ready-mix equipment but that the crisis was averted. We cannot, however, determine whether avoiding the crisis merely reduced the imminence of the threat, postponing it tem-

porarily, or whether the threat substantially disappeared. Nor is it clear whether these events occurred prior to 1945, the first of the taxable years in question, or at some later date, in which case, even assuming that the threat thereupon ended, the tax result for a portion of the five-year period might have been considerably affected.

As a second reason for not recognizing petitioner's claimed need for retaining resources to finance its entry into the ready-mix concrete business, the Tax Court asserted that since petitioner's stock was owned by one person, "the money would still have been available to petitioner for such an emergency, even if distribution had been made." The authorities cited by the Tax Court are *Helvering* vs. *National Grocery Co.*, 304 U. S. 582, and *Helvering* vs. *Chicago Stock Yards Co.*, 318 U.S. 693, and particularly the following sentence from the *National Grocery Co. case*: "Since Kohl was the sole owner of the corporation, the business would have been as well protected against unexpected demands for capital, and assured of capital for the purpose of any possible expansion, by his personal ownership of the securities as by the corporation's owning them." The very next sentence, however, in the opinion of the Supreme Court in the *National Grocery Co. case* is: "Moreover, no conceivable expansion could have utilized so large a surplus."

The first of these cited sentences must be read in the context of the whole opinion, from which it is plain enough that even without it, the decision would have been the same. Furthermore, were the statement deemed the controlling rationale of the decision, it would be authority for denying all sole stockholder corporations the right ever to maintain accumulations even for reasonable needs. The test expressed by the statute would then be completely abandoned. This, however, has not been the understanding of the Commissioner or the Tax Court, and if it were, disallowance would be automatic and there would be no

point to the elaborate computations of reasonable needs which are found in the adjudicated cases.

Moreover, in an enlightening footnote, the Supreme Court pointed out that had the amount of $582,850.38, the accumulation of earnings in question, been distributed to the sole stockholder, he would have incurred additional surtax liability of only $90,744.56. *Helvering* vs. *National Grocery Co.*, *supra*, p. 292, footnote 9. This tax would have been less than sixteen percent of the amount distributed. In the instant case the alleged Section 102 income for the tax years 1945 to 1950, inclusive, totaled $1,342,834.45, which, if distributed, would have resulted, as the Tax Court noted, in additional surtax liabilities to Mr. Smoot of almost $1,200,000.00, or approximately eighty-nine percent.

Clearly, in the tax economy of the period covered by the instant case, it can hardly be said that a distribution after deduction of income taxes by a high surtax bracket taxpayer is "available" for reinvestment in the corporation.

In any event, all that Justice Brandeis said in the quotation was that a corporation may not accumulate surplus for "unexpected demands." This is true regardless of whether it is owned by a single stockholder or by a larger group. Unexpected demands and unanticipated emergencies are not the reasonable needs for which a corporation may provide under Section 102 and are not contended for by this taxpayer. However, a contingency is a reasonable need for which a business may provide, if the likelihood, not merely the remote possibility, of its occurrence reasonably appears to a prudent business firm.

Accordingly, we think the Tax Court should decide whether petitioner reasonably believed that it would likely be forced into the ready-mix business during any of the taxable years in question and, if so, what sum was needed therefor.

The measure of the capital needed for such a purpose would be the extent and degree to which petitioner intended to engage in ready-mix activities and not the cost required to enter the business on the same scale as some other particular ready-mix concerns. Further, the Court should have determined when, if at all, the threat terminated and became too remote a possibility to justify reserves or, alternatively, whether petitioner abandoned its intentions, although the threat persisted. These issues demanded resolution and are not satisfied by a finding that petitioner never intended to go into the ready-mix business of its own free will, or by a finding that the feared contingency never developed. Without determining the highly pertinent issues we have indicated, the Tax Court could not properly calculate petitioner's financial requirements, and the failure to make findings on these issues was error on its part.

It is not necessary for a corporation to create surplus reserves on its books to cover its future business needs, as the petitioner here did. The Statute imposes no such evidentiary requirement, nor is the mere book entry conclusive, in a Section 102 case, that the reserve is for a reasonably anticipated business need. Also, sufficient capital resources may be available regardless of any specific reserve on the books. The Tax Court may well give weight to the fact that only $500,000.00 was set up in this reserve and that this figure was not changed during the period covered by this case. Or the Court may conclude that the idea of going into the ready-mix business is not genuine, but merely a fictitious facade to cover an unreasonable accumulation of surplus; if so, it may disallow the item in its entirety.

V.

In the course of a hypothetical analysis of petitioner's claim that it needed $3,000,000.00 in working capital, including self-insurance reserves, the Tax Court treated $500,000.00 as adequate working capital for petitioner,

exclusive of self-insurance reserves. This determination was based upon the formula that "accumulation of funds to meet operation expenses for at least one year is reasonable," citing *J. L. Goodman Furniture Company*, 11 TC 530. It is apparently true, as petitioner claims, that the Tax Court, in applying this formula, used only those indirect expenses on petitioner's profit and loss statements, which did not include the cost of goods sold. Petitioner did, however, have direct expenses, such as wages, fuel, and supplies, which, on its operating statements, were included in the cost of goods sold. These costs ranged from $484,647.00 to $778,043.00 in the five years in question. Such expenses were not recognized by the Tax Court in applying its formula, and we cannot ascertain from the decision and opinion whether the exclusion of the direct operation costs was intentional or, as petitioner asserts, inadvertent.

In the *Goodman Furniture Company case*, the Tax Court did not limit the working capital requirements of the taxpayer in that case to an amount sufficient to meet one year's operating expenses. The Tax Court in that case included in the calculation of working capital, allowances for inventories, accounts receivable and, *in addition*, funds sufficient to meet one year's operating expenses; and furthermore, the Tax Court in that case was dealing with a retail installment merchant.

Obviously, the working capital formula cited by the Tax Court in the instant case was only part of the formula used in the *Goodman Furniture Company case*. Perhaps the Tax Court, in citing the formula, believed that in the instant case it need make no allowance for direct expenses making up cost of goods sold because of weight given to evidence presented at the trial. But we cannot determine this from the Tax Court's decision.

Of course, even the complete formula used in *Goodman* to determine working capital may not be applicable without discrimination in all cases. Working capital needs of

businesses vary, being dependent upon the nature of the business, its credit policies, the amounts of inventories and rate of turnover, the amount of accounts receivable and the collection rate thereof, the availability of credit to the business, and similar relevant factors.

In our view, the Tax Court should make a determination of petitioner's working capital needs based upon the foregoing considerations. A clear disclosure of the method by which the Court computed the working capital required would not only go a long way to dispose of the issues in the instant case but could be useful to the legal and accounting professions as a future guide.

VI.

The final contention of the petitioner is that the deficiency notices were void, because issued as a result of improper administrative procedures. It is asserted that the officials who signed the deficiency notices did not personally know the facts on which they acted, but accepted the recommendations of subordinates. The record provides ample basis for the Tax Court's finding that in determining the deficiency, subordinate officials made the necessary examination of petitioner's tax returns. The official authorized to sign the notices is not required to know all of the details of fact in each case, but he may act on the investigation and findings of those responsible to him. To hold otherwise would burden and impede the administration of the law beyond the hope of practical efficiency.

It is also argued that the notice contained no determination of what the resulting taxes would have been upon distribution of earnings to petitioner's sole stockholder, Columbia, and to the latter's sole stockholder, L. E. Smoot. This contention is likewise lacking in merit. Not only were all the facts pertaining to the tax returns of Mr. Smoot individually, as well as of the two corporations which he controlled, in the possession of the Commissioner's repre-

sentatives, but, as the Respondent points out, these facts had been the subject of intensive inquiry and repeated conferences between the taxpayer and the Commissioner. We agree with the Tax Court that the Commissioner's assertion of Section 102 surtax inferentially carried with it the determination that failure to distribute earnings resulted in tax savings to the stockholders. *J. M. Perry and Company, Inc.* vs. *Commissioner* (Cir. 9), 120 Fed. 2d 123.

The broad conclusions in the final paragraph of the Tax Court's decision as to the absence of reasonable need are based upon its step by step analysis of petitioner's claims. Inasmuch as we have shown that as to the issues of additional working capital and entry into the ready-mix business, the reasons assigned for disallowance are inadequate, the conclusions drawn do not follow. This is not to say that the Tax Court may not upon rehearing reach the same conclusions, but for proper reasons.

Accordingly, we affirm the Tax Court on all issues except as to the working capital (exclusive of self-insurance reserves) necessary in petitioner's business and as to the ready-mix business, and remand the case to the Tax Court for findings in those respects in accordance with the views expressed in this opinion.

Reversed and remanded.

IN THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 7265

THE SMOOT SAND & GRAVEL CORPORATION, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

Order

Upon consideration of the Appellant's motion for rehearing and for modification of the Court's opinion, it is, this 4th day of March, 1957, by the United States Court of Appeals for the Fourth Judicial Circuit, ORDERED that footnote 4, to which the Petitioner's counsel objects as ascribing "opprobrium" to him (although we do not agree that it does), BE AND THE SAME IS HEREBY, deleted.

MORRIS A. SOPER
United States Circuit Judge
CHARLES FAHY
United States Circuit Judge
SIMON E. SOBELOFF
United States Circuit Judge

FILED

Mar 8 1957

R. M. F. WILLIAMS, JR.
Clerk

A true copy,

Teste:

RICHARD M. F. WILLIAMS, JR., *Clerk*,
U.S. Court of Appeals for the
Fourth Circuit

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 7886.

THE SMOOT SAND & GRAVEL CORPORATION, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

ON PETITION TO REVIEW THE DECISIONS OF THE TAX COURT OF THE UNITED STATES.

(Argued October 19, 1959. Decided January 11, 1960.)

Before SOBELOFF, Chief Judge, and SOPER and BOREMAN, Circuit Judges.

David R. Shelton for Petitioner, and David O. Walter, Attorney, Department of Justice, (Charles K. Rice, Assistant Attorney General; Lee A. Jackson and A. F. Prescott, Attorneys, Department of Justice, on brief) for Respondent.

SOBELOFF, Chief Judge:

This case, here for the second time, concerns the taxpayer's liability for the years 1945-1950 for surtaxes under

§ 102 of the Internal Revenue Code of 1939[1] by reason of the alleged accumulation of profits "for the purpose of preventing the imposition of the surtax" upon its sole shareholder, Columbia Sand & Gravel Company, Inc., and upon L. E. Smoot, owner of all the common stock of Columbia. The Tax Court having sustained the Commissioner's position in the first trial of the case, this court, on review, concluded its opinion as follows:

> "Accordingly, we affirm the Tax Court on all issues except as to the working capital (exclusive of self-insurance reserves) necessary in petitioner's business

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[1] Section 102 provides, in relevant part, as follows:

> "SEC. 102. SURTAX ON CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS.
>
> (a) [as amended by Sec. 103(d), Revenue Act of 1941, c. 412, 55 Stat. 687] *Imposition of Tax.* There shall be levied, collected, and paid for each taxable year (in addition to other taxes imposed by this chapter) upon the net income of every corporation (other than a personal holding company as defined in section 501 or a foreign personal holding company as defined in Supplement P) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:
>
> 27½ per centum of the amount of the undistributed section 102 net income not in excess of $100,000, plus
>
> 38½ per centum of the undistributed section 102 net income in excess of $100,000.
>
> • • • • • •
>
> (c) *Evidence Determinative of Purpose.*—The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary."
>
> • • • • •

and as to the ready-mix business, and remand the case to the Tax Court for findings in those respects in accordance with the views expressed in this opinion." *Smoot Sand & Gravel Corp.* v. *Commissioner*, 241 F.2d 197, 208 (1957), cert. den. 354 U. S. 922, reh. den. 354 U. S. 943.

After remand, the Tax Court took further evidence and again upheld the Commissioner's imposition of surtaxes under § 102.

The background of this controversy is fully set forth in the two memoranda of the Tax Court, T.C. Memo 1956-82 and T. C. Memo 1958-221, respectively, and in our earlier opinion at 241 F.2d 197. It would serve no useful purpose to repeat all the facts that have been developed in the course of the litigation, but as we proceed we shall outline the evidence relevant to the disposition of the present issues.

Three main questions are involved on this review:

I. Did taxpayer's officers *reasonably believe* that it was necessary to accumulate earnings and profits, since the taxpayer might have to enter the ready-mix concrete business?

II. How much working capital was needed by the taxpayer?

III. Upon whom is the burden of proof as to the asserted unreasonable accumulation of earnings and profits?

I

Did the taxpayer *reasonably believe* in the years 1945-1950 that it would likely be forced into the ready-mix concrete business, thus justifying an accumulation of earnings and profits for that purpose? The Tax Court has now found that the taxpayer never intended to enter the business; never formulated any definite plans for doing so; was not at any time during the years in question under any real

threat from its customers or its competitors which might reasonably have been regarded by petitioner's officers as likely to force taxpayer into the ready-mix business; that "if any such threat ever existed it did not extend beyond 1940 at the latest." In sum, the finding is that "petitioner's officers had no reasonable cause to consider petitioner's entry into the ready-mix business as more than a remote possibility, or to accumulate petitioner's earnings and profits for that purpose."

It is the taxpayer's initial contention that the Tax Court found in its favor on this issue at the first trial and changed this finding in the second although no further unfavorable evidence was adduced. Great emphasis is placed by the taxpayer on the following passage of the Tax Court's first memorandum opinion:

> "In the meantime, the ready-mix concerns began demanding certain price concessions and other concessions which petitioner was unable or unwilling to grant, and transferring as much of their business as possible to petitioner's competitors. By 1945 this situation had reached the point where, *in the opinion of petitioner's officers,* it constituted a severe threat to petitioner's business. Petitioner was confronted with the alternative of going into the ready-mix business itself or losing the major portion of its sand and gravel market." (Emphasis supplied.)

We believe, however, that the Tax Court explains this statement adequately in its second opinion, when it declares,

> "In our original findings of fact we found that in the opinion of petitioner's officers, the actions of the ready-mix concerns in the vicinity of petitioner's business posed a serious threat to the continuation of the business as operated by petitioner, and that petitioner might eventually be forced into the ready-mix business itself. This finding was based on the testimony

> of petitioner's officers as to their state of mind during the critical period, some 6 to 10 years previously. We did not find that any such threat to petitioner's business constituted a reasonable need for a cash reserve sufficient to equip the petitioner for entry into the ready-mix business on a competitive basis, or what would have been a reasonable amount for such a reserve."

Taxpayer's main contention on this issue appears to be that its officers sincerely believed that it would be forced into the ready-mix industry because "[f]rom 1940 on petitioner was under heavy attack from powerful financial forces seeking to destroy and take its business." Taxpayer's brief continues as follows:

> "Also, on the basis of its long and repeated experiences, petitioner knows that those seeking to take or destroy its business will stop at nothing and will resort to such tactics as attempts to have Mr. Smoot indicted under the anti-trust laws, attempts to have petitioner's business destroyed under the anti-trust laws, attempts to have petitioner's business destroyed under the penalty surtax provisions of the Internal Revenue Code, attempts to have its customers' bank credit cut off if they continue to be petitioner's customers, and so on."

Eloquent but unsupported assertions in the brief do not take the place of testimony or proof. The "powerful financial forces" (also referred to, in taxpayer's brief, as "powerful invading financial interests from outside of Washington") are not identified by petitioner, nor is there evidence in the record of any threats made or pressures brought to bear against petitioner in the 1945-1950 period. The taxpayer's unsubstantiated allegations do not require or even permit a finding that it entertained at the time a

reasonable belief that it would have to enter the ready-mix business.

In further support of its asserted "reasonable belief," taxpayer presses several other considerations. It declares that at the end of World War II it was in a seriously weakened condition since its inventory and productive facilities were exhausted to such a point that it could not satisfy all the orders of its customers. Taxpayer maintains that "[d]ue to its weakened condition petitioner's management felt strongly that it was in greater peril than ever before from the ready-mix concrete industry during the 1945-1950 period." The proposed inference of weakness does not necessarily follow, and there is nothing more than bare assertion to support it. That the Tax Court interpreted petitioner's situation in a different light is evident from its finding that ". . . petitioner was in a strong economic position with more demands on its production than it could meet . . ." We think that the Tax Court was certainly not without warrant in its conclusion that taxpayer's inability to supply the demands on its production is, in the circumstances of this case, evidence of a strong, not a weak, economic position. Strong or weak, it sheds no light on the issue of whether the corporation, willingly or unwillingly, anticipated going into the ready-mix business.

Next, petitioner insists that "[b]y 1945 substantially every major sand and gravel producer had been *forced* into the ready-mixed concrete business or *destroyed and absorbed* by that industry." (Emphasis supplied.) However, one of taxpayer's own witnesses, Vincent P. Ahearn, Executive Secretary of the National Sand and Gravel Association and the National Ready-Mixed Concrete Association, in explaining why the sand and gravel companies themselves have developed ready-mix concrete businesses, testified:

> "It is a logical development because the sand and gravel producer produces two of the ingredients—of

> the industry, the fine and the coarse aggregate. Furthermore, he has the necessary facilities—the yards, the hoists, and the draglines. In many cases he has the staff to help develop the business. He had to expand his industry and his equipment, but it was more logical for him to do it in nearly every case than it was for a newcomer to come into the field. . . ."

There is not a word here about sand and gravel producers being *forced* into the ready-mix business or else being *destroyed and absorbed*. It is undisputed that the corporation did not, voluntarily or involuntarily, enter this business at any time. The Tax Court did not exceed reasonable limits in concluding from all the testimony in the case that there was at the time no reasonable cause to consider petitioner's entry into this new enterprise more than a remote possibility.

Another circumstance cited by petitioner is that it "kept from $3,000,000 to $3,300,000 on deposit in the Riggs National Bank, without interest, in the hope that those seeking to destroy or take its business would be deterred." This is treated as strong proof of its contention; yet petitioner does not really tie in the deposit with the alleged reasonable belief that it would be forced to engage in the ready-mix business. The fact that it kept on hand a large balance of uninvested cash is entirely neutral in respect to the issue the Tax Court was called upon to decide. There may have been other reasons for maintaining this accumulation, such as the expectation of deflation felt by many at the close of the war. In our earlier opinion, we noted that petitioner claimed to be "awaiting 'the usual post-war deflation.'" 241 F.2d 197, 202 (4th Cir., 1957).[2]

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[2] It is also noteworthy that while the taxpayer claims to have retained over $3,000,000 in cash to impress competitors with its ability to enter the ready-mix business, its balance sheets during the years in question show a reserve of only $500,000 for the purchase of concrete mixing equipment. See n. 4 *infra*.

Finally, taxpayer points to the Tax Court's decision in *Breitfeller Sales, Inc.*, 28 T.C. 1164 (1957), as contrary to its holding here. On the facts of that case the taxpayer, an automobile dealer, was held justified in accumulating earnings because of the "possibility that it might be required to finance a new dealership . . ." It should be observed that a "contemplated" expansion must be shown to have been a real consideration during the taxable year, and not simply an afterthought to justify challenged accumulations of surplus. *Helvering* v. *National Grocery Co.*, 304 U. S. 282 (1938); *Hedberg-Friedheim Cont. Co.* v. *Commissioner*, 251 F.2d 839 (8th Cir., 1958). The finding in *Breitfeller* was that the taxpayer's directors, during the years in issue, "reviewed and approved plans and policies for expanding facilities, making provision for protection of petitioner's 'interest' in the St. Albans area, and the possible financing of installment sales of automobiles." 28 T. C. 1164, 1167. In the case at bar, however, there was no such evidence and no such finding; on the contrary, what the Tax Court did find was that the petitioner never intended to enter the ready-mix business and never formulated definite plans for doing so.

II

How much working capital was needed by the taxpayer in the years from 1945 to 1950? In our earlier opinion, we said that:

> "Working capital needs of businesses vary, being dependent upon the nature of the business, its credit policies, the amount of inventories and rate of turnover, the amount of accounts receivable and the collection rate thereof, the availability of credit to the business, and similar relevant factors.
>
> In our view, the Tax Court should make a determination of petitioner's working capital needs based

upon the foregoing considerations. . . ." 241 F. 2d 197, 207 (4th Cir., 1957).

The Tax Court has now found that most of petitioner's sales during the years in question were for cash, payable within 30 to 60 days; that the average inventory turnover period was less than 4 days; that the average closing inventory of sand and gravel, at the end of each year, that is "Finished Goods," was not over $5,000.00; that the "Raw Materials" inventory was even less; that credit was readily available to petitioner; that the nature of the operations was such as to require a working capital reserve "for very much less than a full year"; and that, in conclusion, considering the above factors, as well as petitioner's direct and indirect expenses and cost of goods sold, "petitioner's working capital requirements would not have been in excess of between about $200,000 and $350,000 at any given time for the years under consideration." Petitioner's need for working capital for each of the taxable years was estimated by the court as follows:

Year	Reasonable Working Capital
1945	$201,997.45
1946	191,693.94
1947	197,557.52
1948	248,191.08
1949	351,667.37
1950	333,826.67

The Tax Court then turned to a broader consideration of the petitioner's financial situation in the relevant years. After an analysis of stipulated balance sheets taken from income tax returns, and in light of the other evidence, the court concluded that the Commissioner's imposition of surtaxes for unreasonable accumulations of surplus was proper. Its computation follows:

	12/31/45	12/31/46	12/31/47
Reserves per books	$4,298,728.25	$4,347,084.39	$4,464,566.42
Surplus not "Earmarked"	2,088,596.99	2,276,848.46	2,543,351.52
Total surplus	$6,387,325.24	$6,623,932.85	$7,007,917.94
Less:			
Reserves accepted as reasonable	$4,298,728.25	$4,347,084.39	$4,464,566.42
Loans to customers	72,917.00	.....	125,000.00
Working capital	500,000.00	500,000.00	500,000.00
Unreasonable accumulation	$1,515,679.99	$1,776,848.46	$1,908,351.52

	12/31/48	12/31/49	12/31/50
Reserve per books	$4,623,732.11	$4,566,666.38	$4,738,103.32
Surplus not "Earmarked"	2,618,292.96	2,697,915.75	2,908,702.60
Total surplus	$7,242,025.07	$7,264,582.13	$7,646,805.92
Less:			
Reserves accepted as reasonable	$4,623,732.11	$4,566,666.38	$4,738,103.32
Loans to customers	150,000.00	.....	92,505.00
Working capital	500,000.00	500,000.00	500,000.00
Unreasonable accumulation	$1,968,292.96	$2,197,915.75	$2,316,197.60

After this preliminary examination of the Tax Court's findings we look more closely at the applicable statutory provisions. Section 102 (a) provides that a surtax shall be imposed on corporations which are formed or availed of for the purpose of avoiding the surtax on its shareholders by permitting earnings and profits to accumulate instead of being distributed to the shareholders. Section 102 (c) provides that the fact that earnings and profits are permitted to accumulate beyond the *reasonable needs* of the business is *determinative* of the purpose to avoid surtax upon shareholders unless the corporation proves the contrary by the clear preponderance of the evidence. Thus, the size of the accumulated earnings and profits or surplus is not the crucial factor; rather, it is the reasonableness and nature of the surplus. Part of the surplus may be justifiably earmarked in the form of reserves, for specific, necessary business needs.[3] Again, to the extent the surplus has been

[3] In this connection, we think it appropriate to reiterate what was said in our earlier opinion in this case:

> "It is not necessary for a corporation to create surplus reserves on its books to cover its future business needs, as the petitioner here did. The statute imposes no such evidentiary

translated into plant expansion, increased receivables, enlarged inventories, or other assets related to its business, the corporation may accumulate surplus with impunity. Lasser and Holzman, *Corporate Accumulations and Section 102*, 93 (1949) and cases cited therein. Where, on the other hand, the accumulation of surplus is reflected in liquid assets in excess of the immediate or reasonably foreseeable business needs of the corporation, there is a strong indication that the purpose of the accumulation is to prevent the imposition of income taxes upon dividends which would have been distributed to the shareholders. Hall, "The Taxation of Corporate Surplus Accumulations," Joint Committee on the Economic Report, 82nd Cong., 2nd sess., quoted in Bittker, *Federal Income, Estate, and Gift Taxation* (2nd ed., 1948), 487; see also Mertens, *Law of Federal Income Taxation*, §39.51 (1956) and cases cited therein.

The ultimate question whether a corporation is availed of for the purpose of avoiding surtax on shareholders is one of fact. Unless the finding of the Tax Court is clearly erroneous, it should not be disturbed by the Court of Appeals. 26 U.S.C.A. Sec. 7482(a); *Casey* v. *Commissioner*, 267 F.2d 26 (2nd Cir., 1959); *Pelton Steel Casting Co.* v. *Commissioner*, 251 F.2d 278 (7th Cir., 1958). In order to determine whether the Tax Court's conclusions are clearly erroneous, we shall review the petitioner's financial condition for these years. In so doing, we shall address ourselves directly to the petitioner's contention that the Tax Court made the "astonishing mistake" of failing to grant allowances for the amounts specifically found by the Tax Court in its first opinion as properly allowable as reserves for (1) bad debts, (2) depreciation, (3) depletion, and (4) tax liabilities, allegedly ranging from $2,898,337.12 to $4,276,070.98 during the 1945-1950 period.

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requirement, nor is the mere book entry conclusive, in a Section 102 case, that the reserve is for a reasonably anticipated business need." 241 F. 2d 197, 207 (4th Cir., 1957).

Appended are the balance sheets for each of the tax years in question, and we examine the figures for 1945 as fairly illustrative.[4] It will be seen that the reserves earmarked out of surplus total $4,298,728.25; the surplus not earmarked is $2,088,596.99; the total surplus is thus $6,387,325.24. Of this sum, the Tax Court accepted as reasonable all the reserves earmarked on the balance sheet.[5] Taxpayer now asserts that the reserves accepted by the Tax Court are insufficient and that additional allowances should have been made to cover *bad debts, depreciation and depletion.*

A reserve for *bad debts*, or allowance for doubtful accounts represents an estimate of the amount of the accounts and notes receivable which will be uncollectible. The purpose of the reserve is (1) to charge the loss against the period in which it was actually incurred as a result of the sale of goods to customers whose accounts subsequently prove to be uncollectible and (2) to show the estimated realizable value of the customers' accounts. Finney & Miller, *Principles of Accounting—Intermediate*, 207 (5th ed., 1958). A taxpayer using the reserve method is allowed, under the Internal Revenue Code,[6] to charge off this estimated amount as an expense of its current operations. The appropriate accounting entry is to debit or charge an account called "bad debt expense" and to credit an account called "reserve for bad debts." The amount charged to bad debt expense is deducted by the taxpayer in computing his annual profit or loss. Therefore, this reduces net income for the year and likewise reduces the surplus account of the business. On the balance sheet, accounts receivable and notes receivable are shown *net* of the reserve for bad debts, and only the net figure is deemed to show the value of the

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[4] See Appendix.

[5] See n. 3 *supra*.

[6] Internal Revenue Code of 1939, Section 23 (k)(1); Internal Revenue Code of 1954, Section 166 (c).

receivables. The taxpayer is thus totally incorrect when it claims additional reserves for bad debts, because the bad debt expense has already been eliminated from surplus; moreover, only the *net* receivables were considered by the court in evaluating the taxpayer's assets which are available for dividends.

For the same reasons, the taxpayer's argument concerning the reserves for *depreciation and depletion* cannot be accepted. Surplus has already been reduced by annual charges to depreciation expense and to depletion expense; allowing them again would give the taxpayer double deductions. We are cognizant of the fact that replacement of taxpayer's wasting assets will ultimately become necessary, and that for this purpose cash or other liquid assets must be available; but, as will appear, taxpayer had much more liquidity than necessary for such replacement and for all other reasonable business needs.

Likewise, petitioner complains that it was denied a reserve for additional *income tax liabilities asserted* by the Commissioner in the following *alleged* amounts:

1945	$ 723,166.73
1946	1,155,907.50
1947	1,717,317.99
1948	1,794,562.00
1949	434,803.71
1950	516,275.17

It is undisputed that in 1946 a notice of deficiency was sent to taxpayer asserting deficiencies in income and excess profit taxes for the years 1940 to 1944 in the total amount of $922,619.84. At the same time, deficiencies were asserted against Columbia Sand & Gravel Company, Inc., and L. E. Smoot, individually. The claims against all three were settled in 1949. The taxpayer's deficiencies were determined to be $301,512.06 and were paid in 1949 and 1950.

The amounts of the deficiencies which the taxpayer alleges were asserted against it are nowhere proved, except

as to the $922,619.84. It should be observed that on the petitioner's balance sheets, a reserve for federal income tax appears for each of the years in question, but in much smaller amounts than are now alleged. Petitioner declares that its income tax liability, in the amounts stated above, was specifically found by the Tax Court in its first opinion. This is a bold claim in light of what the Tax Court actually said:

> "The additional tax liabilities determined against the petitioner for the years 1940 to 1944, inclusive, which were outstanding at the close of the years 1945 to 1950, inclusive rose from less than $1,000,000 in 1945 to a peak in 1948 of $1,794,562, including interest. We recognize, of course that petitioner was entitled to maintain a cash reserve sufficient to pay any tax liabilities which had been determined against it, except perhaps section 102 tax. At the same time, however, it is perfectly obvious that petitioner at all times during the 1945-1950 period had sufficient ready capital on hand over and above all asserted needs.
>
> A word may perhaps be appropriate as to the size of the tax liabilities claimed by petitioner to have existed in the taxable years. *Petitioner adds to its own deficiencies those determined against Columbia, its sole stockholder, and Smoot, Columbia's sole stockholder.* But while petitioner may have been entitled to retain funds for the payment of its own indebtedness, we think it clear that no supposed liabilities involving its immediate and remote stockholders, could be characterized as a need of its business. A distribution of its profits would have put those stockholders in funds so that they in turn could meet whatever tax liabilities might ultimately be imposed." (Emphasis supplied.)

Even if we assume that the taxpayer was entitled to an allowance of some part of the amount it claims, in excess of the allowances made, as a reserve for tax liability, the failure to grant this would not change the result in this

case, since all *proper* allowances would still be insufficient to account for the accumulations of surplus.

In its analysis of petitioner's financial condition the Tax Court accepted as reasonable all the reserves listed on the balance sheets, stating that "although in some cases the items included are doubtful as to character or amount, the benefit of that doubt has been extended in petitioner's favor." The court added that:

> "... as to a number of items on which the amount of the reserve was virtually the only evidence of a reasonable figure for the business needs, we may have fallen into error in viewing them as a proper measure of reasonable accumulations. Such items are, for example, $500,000 for ready-mix as originally allowed although it now appears that this allowance is overgenerous, reserves for Federal income taxes and contract bonds. Since, however, we regard these issues as no longer open upon the remand, we have retained the original figures in our summary."

We can understand the court's impression that the issue as to several of the reserves was no longer open upon the remand. However, we agree that the court was, to use its own word, "overgenerous" in the second proceeding, since it allowed (1) $500,000 for the purchase of concrete mixing equipment, in spite of its specific finding that the taxpayer did not need to accumulate any amounts whatever for this purpose, (2) $500,000 for working capital, although the court found taxpayer's needs to be less than this, (3) $250,000 for contract bonds, although this court held, in its earlier opinion, that no justification appears for this reserve.[7] Furthermore, it should be noted that in our earlier opinion, we concluded that in the existing circumstances, "it is difficult to perceive any justification for creating a reserve for bond indebtedness," i.e., accrued interest on the corporation's bonds held by Mr. Smoot individually.

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[7] 241 F. 2d 197, 203-204 (4th Cir., 1957).

241 F.2d 197, 204 (4th Cir., 1957). Finally, we have considerable doubt about the allowance of the large reserve in the sum of $1,333,000 for post war rehabilitation, which apparently merely involves future replacement of depreciated and depleted assets. We have previously noted that depreciation and depletion charges are deducted from surplus during the useful life of assets. Replacement of assets which are fully depreciated or depleted requires available cash but does not require a second appropriation of surplus. It is only when rehabilitation plans involve replacement of old equipment with equipment costing more than the original, or when additional equipment is required, that appropriation of surplus is justified. As stated in our earlier opinion, the taxpayer was not expecting inflation but deflation. None of the possible justifications for additional replacement reserves has been shown. On balance, it is clear enough that, however viewed, the allowances made by the Tax Court exceed any amount the taxpayer could possibly justify as reasonable reserves.

Having examined the reserves needed by the business, we turn to the amount of liquid assets available to meet these needs. In 1945, taxpayer had the following liquid assets:

Cash	$2,950,115.64
Net notes and accounts receivable	94,063.36
Inventories	47,619.01
Investments:	
Obligations for U.S., State, etc.	1,324,531.72
Other securities	7,922.34
Net loans secured and unsecured	1,091,628.89
	$5,515,880.96

Its only current liability was Accounts Payable, $1,092.59. Thus, petitioner had liquid assets of more than $5,500,000, much in excess of what was reasonably required in the business (even after taking into consideration amounts necessary to replace depreciated and depleted property).

Analysis of the other years in issue discloses a similar picture and leads to the same conclusion of unreasonable accumulations.

Viewed in broader context, the corporation's record of earnings and dividends over the years is also quite revealing. In every year since 1927 taxpayer has had net earnings in amounts ranging from approximately $200,000 to over $1,000,000. Twice only in this period has it declared dividends, $20,000 in 1928 and $800,000 in 1932. In the latter year, when L. E. Smoot reported the dividends of $800,000 in his individual income tax return, he had offsetting loss deductions of over $600,000. No other dividends have ever been paid, and the company's surplus has been permitted to swell.

The Tax Court's conclusion, far from being clearly erroneous, seems to be clearly correct.

III

On the question of burden of proof the Tax Court decided that, in the circumstances of this case, the burden of proof rests with the taxpayer, notwithstanding Sec. 534 of the Internal Revenue Code of 1954, 26 U.S.C.A., Sec. 534.[8] We need not decide the point here since, even assuming that the burden of proof was on the Government, we are convinced, as was the Tax Court, that this burden has been met by affirmative proof of "a deliberate, consistent and inescapable intention to retain its net earnings for the purpose of avoiding the surtax upon its immediate and ultimate stockholders."

The decisions of the Tax Court are

Affirmed.

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[8] Section 534 of the 1954 Code provides that the burden of proof shall be shifted to the Government if, after receiving notification from the Secretary or his delegate of an intention to assert a deficiency on the basis of unreasonable accumulation of earnings, the taxpayer submits a statement of the grounds (together with facts sufficient to show the basis thereof) on which it relies to escape the tax on all or any part of the earnings and profits by establishing the accumulations have been reasonable.

APPENDIX

THE SMOOT SAND & GRAVEL CORPORATION (DELAWARE)

Balance Sheets Taken from Income Tax Returns
1945 through 1950

	Dec. 31, 1945	Dec. 31, 1946	Dec. 31, 1947	Dec. 31, 1948	Dec. 31, 1949	Dec. 31, 1950
Cash	$2,950,115.64	$3,209,133.31	$3,311,060.72	$2,971,795.84	$3,213,854.38	$3,332,387.37
Notes & Accounts Receivable	106,563.36	179,721.60	192,233.13	211,176.94	24,786.03	206,071.60
Less Reserve	12,500.00	12,500.00	12,500.00	12,500.00	12,500.00	12,500.00
Net notes & accounts receivable	94,063.36	167,221.60	179,733.13	198,676.94	12,286.03	193,571.60
Inventories	47,619.01	65,765.87	65,719.43	74,390.15	64,950.23	59,929.91
Investments:						
Obligations of U. S., State, etc.	1,324,531.72	1,344,756.72	1,268,756.72	1,261,256.72	1,253,756.72	1,200,425.00
Other Securities	7,922.34	7,822.34	7,822.34	7,822.34	7,822.34	7,522.34
Leases						
Loans secured & Unsecured	1,212,920.99	1,144,166.39	1,432,971.09	1,924,048.23	1,811,843.23	1,852,786.52
Less Reserve	121,292.10	114,416.64	143,297.11	192,404.82	181,134.32	185,278.65
Net loans secured & Unsecured	1,091,628.89	1,029,749.75	1,289,673.98	1,731,643.41	1,630,208.91	1,667,507.87
Land	418,816.49	417,820.20	417,820.20	414,820.20	415,020.20	411,847.67
Buildings	359,644.46	359,644.46	359,644.46	347,818.96	347,818.96	350,255.20
Machinery & Equipment	1,925,790.78	1,932,612.32	2,094,430.16	2,293,959.12	2,479,370.34	2,535,444.91
Furniture & Fixtures	8,671.46	8,671.46	9,130.39	12,686.95	12,686.95	12,686.95
Total depreciable assets	2,294,106.70	2,300,928.24	2,463,205.01	2,654,465.03	2,839,876.25	2,898,387.06
Less Reserve	1,692,693.13	1,769,730.39	1,846,400.08	1,924,507.00	2,013,792.83	1,994,733.87
Net depreciable assets	601,413.57	531,197.85	616,804.93	729,958.03	826,083.42	903,653.19
Dredging rights	522,425.17	522,425.17	522,465.17	526,990.17	521,962.87	521,962.88
Less Reserve	348,685.16	348,685.16	348,685.16	352,097.16	359,054.16	363,685.16
	173,740.01	173,740.01	173,780.01	174,893.01	162,908.71	158,277.72
Goodwill Columbia Sand & Gravel Co.	293,521.65	293,521.65	293,521.65	293,521.65	293,521.65	293,521.65
Prepaid Insurance	545.15	149.80	.....	.....	.....	.....
Deposit (new scows)	.....	.....	.....	.....	.....	43,235.21
Total Assets	$7,003,917.83	$7,240,879.10	$7,624,693.11	$7,858,778.29	$7,880,412.59	$8,271,879.53

Liabilities & Capital						
Accounts Payable	$ 1,092.59	$ 1,446.25	$ 1,275.17	[redacted].22	$ 330.46	$ 9,573.61
Bonds & Notes	615,500.00	615,500.00	615,400.00	[redacted].00	615,500.00	615,500.00
Reserve for insurance replacements & contingencies; Replacement reserve Sand & Gravel	4,298,728.25	4,347,084.39	4,464,566.42	4,623,732.11	4,566,666.38	4,738,103.32
Capital Stock (300 Com. Sh. of no par value)	.....	.....	.....	.....	.....	.....
Surplus	2,088,596.99	2,276,848.46	2,543,351.52	2,618,292.96	2,697,915.75	2,908,702.60
Total Liabilities and Capital	$7,003,917.83	$7,240,879.10	$7,624,693.11	$7,858,778.29	$7,880,412.59	$8,271,879.53

Summary of Reserves	1945	1946	1947	1948	1949	1950
Reserve for accrued interest (Bond Issue)	$ 652,133.29	$ 689,063.29	$ 725,993.29	$ 762,923.29	$ 799,853.29	$ 836,783.29
Reserve for Contract Bonds	250,000.00	250,000.00	250,000.00	250,000.00	250,000.00	250,000.00
Reserve for Workmen's Compensation Insurance	150,000.00	150,000.00	150,000.00	200,000.00	200,000.00	200,000.00
Reserve for public liability	100,000.00	100,000.00	100,000.00	200,000.00	200,000.00	200,000.00
Reserve for fire and tornado insurance	250,000.00	250,000.00	250,000.00	250,000.00	250,000.00	250,000.00
Reserve for sand & gravel replacement	100,000.00	100,000.00	100,000.00	100,000.00	100,000.00	100,000.00
Reserve for purchase of concrete mixing equipment	500,000.00	500,000.00	500,000.00	500,000.00	500,000.00	500,000.00
Reserve for 1941 income taxes	3,974.55	3,974.55	3,974.55	3,974.55	3,974.55	.....
Reserve for Columbia Company good will	293,521.65	293,521.65	293,521.65	293,521.65	293,521.65	293,521.65
Reserve for 1942 income taxes	16,663.61	16,663.61	16,663.61	16,663.61	.....	.....
Reserve for new Southeast plant	500,000.00	500,000.00	500,000.00	500,000.00	500,000.00	500,000.00
Reserve for post war rehabilitation	1,333,000.00	1,333,000.00	1,333,000.00	1,333,000.00	1,333,000.00	1,333,000.00
Reserve for excess profits tax, post war credit	26,134.21	26,134.21	26,134.21	26,134.21	26,134.21	.....
Reserve for D. C. income tax 1945	10,333.75	.....	.....	.....	.....	.....
Reserve for Federal income tax 1945	112,967.19	.....	.....	.....	.....	.....
Reserve for D. C. income tax 1946	.....	11,745.36	.....	.....	.....	.....
Reserve for Federal income tax 1946	.....	122,981.72	.....	.....	.....	.....
Reserve for D. C. income tax 1947	.....	.....	18,977.52	.....	.....	.....
Reserve for Federal income tax 1947	.....	.....	196,301.59	.....	.....	.....
Reserve for D. C. income tax 1948	.....	.....	.....	16,456.17	.....	.....
Reserve for Federal income tax 1948	.....	.....	.....	171,058.63	.....	.....
Reserve for D. C. income tax current yr.	.....	.....	.....	.....	10,536.08	19,608.22
Reserve for Federal income tax current yr.	.....	.....	.....	.....	99,646.60	255,190.16
Total	$4,298,728.25	$4,347,084.39	$4,464,566.42	$4,623,732.11	$4,566,666.38	$4,738,103.32

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 7886.

THE SMOOT SAND & GRAVEL CORPORATION, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

ON PETITION TO REVIEW THE DECISIONS OF THE TAX COURT OF THE UNITED STATES.

This cause came on to be heard on the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, It is now here ordered and adjudged by this Court that the decisions of the said Tax Court of the United States, in this cause, be, and the same are hereby, affirmed.

January 11, 1960.

SIMON E. SOBELOFF
Chief Judge, Fourth Circuit

A true copy,

Teste:

RICHARD M. F. WILLIAMS, JR., *Clerk*,
U.S. Court of Appeals for the Fourth Circuit.

By MARGARET L. DAVIS,
Deputy Clerk.

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 7886.

THE SMOOT SAND & GRAVEL CORPORATION, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

Order

Upon consideration of the petition for rehearing and the brief in support thereof, the petition is hereby denied.

SIMON E. SOBELOFF
Chief Judge, Fourth Circuit
MORRIS A. SOPER
United States Circuit Judge
HERBERT S. BOREMAN
United States Circuit Judge

FILED
Feb 24 1960
R. M. F. WILLIAMS, JR.
Clerk

A true copy,

Teste:

RICHARD M. F. WILLIAMS, JR., *Clerk*,
U.S. Court of Appeals for the Fourth Circuit

By MARGARET L. DAVIS,
Deputy Clerk.

Statutes, Regulations and Senate Finance Committee Report Involved

Applicable provisions of the Internal Revenue Code of 1939 and Regulations are as follows:

"SEC. 102. SURTAX ON CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS.

"(a) Imposition of Tax.—There shall be levied, collected, and paid for each taxable year (in addition to other taxes imposed by this chapter) upon the net income of every corporation (other than a personal holding company as defined in section 501 or a foreign personal holding company as defined in Supplement P) if such corporation, however, created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

"27½ per centum of the amount of the undistributed section 102 net income not in excess of $100,000, plus

"38½ per centum of the undistributed section 102 net income in excess of $100,000.

* * * * *

"(c) Evidence Determinative of Purpose.—The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary."

Regulations 111—Sec. 29.102-1. Taxation of corporation formed or utilized for avoidance of surtax.—

"Section 102 imposes (in addition to other taxes imposed by chapter 1) a graduate income tax or surtax upon any domestic or foreign corporation formed or availed of to avoid the imposition of the individual surtax upon its shareholders or the shareholders of any other corporation through the medium of permitting earnings or profits to accumulate instead of dividing or distributing them. • • •

Sec. 29.102-3. Unreasonable accumulation of profits.—

"An accumulation of earnings or profits (including the undistributed earnings or profits of prior years) is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case. It is not intended, however, to prevent accumulations of surplus for the reasonable needs of the business if the purpose is not to prevent the imposition of the surtax. No attempt is here made to enumerate all the ways in which earnings or profits of a corporation may be accumulated for the reasonable needs of the business. Undistributed income is properly accumulated if retained for working capital needed by the business; or if invested in additions to plant reasonably required by the business; or if in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation. The nature of the investment of the business, the financial condition of the corporation at the close of the taxable year, and the use of the undistributed earnings or profits will be considered in determining the reasonableness of the accumulations.

"The business of a corporation is not merely that which it has previously carried on, but includes in gen-

eral any line of business which it may undertake. However, a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to avoid the surtax. * * * "

Applicable provisions of the Internal Revenue Code of 1954, as amended, together with explanatory annotations by Prentice-Hall, are as follows:

"SEC. 534. BURDEN OF PROOF.

"(a) General Rule.—In any proceeding before the Tax Court involving a notice of deficiency based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, the burden of proof with respect to such allegation shall—

"(1) if notification has not been sent in accordance with subsection (b), be on the Secretary or his delegate, or

"(2) if the taxpayer has submitted the statement described in subsection (c), be on the Secretary or his delegate with respect to the grounds set forth in such statement in accordance with the provisions of such subsection.

"(b) Notification by Secretary.—Before mailing the notice of deficiency referred to in subsection (a), the Secretary or his delegate may send by registered mail a notification informing the taxpayer that the proposed notice of deficiency includes an amount with respect to the accumulated earnings tax imposed by section 531. In the case of a notice of deficiency to which subsection (c)(2) applies and which is mailed on or before the 30th day after the date of the enactment of this sentence, the notification referred to in the preceding sentence may be mailed at any time on or before such 30th day."

"Amendment.—Sec. 534 (b) appears above as amended by Sec. 5 of Public Law 367, Aug. 11, 1955, which added the sentence beginning with 'In the case'.

"(c) Statement by Taxpayer.—Within such time (but not less than 30 days) after the mailing of the notification described in subsection (b) as the Secretary or his delegate may prescribe by regulations, the taxpayer may submit a statement of the grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business.

• • • •

"(e) Application of Section.—

"(1) Notwithstanding any other provision of law, this section shall apply with respect to taxable years to which this subchapter applies and (except as provided in paragraph (2)) to taxable years to which the corresponding provisions of prior revenue laws apply.

"(2) In the case of a notice of deficiency for a taxable year to which this subchapter does not apply, this section shall apply only in the case of proceedings tried on the merits after the date of the enactment of this paragraph.

"Amendment.—Sec. 534(e) appears above as amended by Sec. 4 of Public Law 367, Aug. 11, 1955, which struck out the following:

"(e) Effective Date.—This section shall apply only with respect to a notice of deficiency for a taxable year to which this subchapter applies which is mailed more than 90 days after the date of enactment of this title.' "

Applicable statements in the Senate Finance Committee Report are as follows (1958 P-H, Volume 1, pp. 4737-4738):

"The technical amendments made by your committee make clear that the shift in the burden of proof under section 534 applies where the issue between the Government and the taxpayer relates to the portion of the earnings and profits which may be accumulated during the taxable year for the reasonable needs of the business. Under the amendment made by your committee to section 535(c), the portion of the earnings and profits for the taxable year which are retained for the reasonable needs of the business is not subject to the accumulated earnings tax. (Senate Committee Report—Detailed Discussion).

"Section 4 of this bill amends the Internal Revenue Code of 1954 to provide that the burden of proof in certain cases involving the accumulated-earnings tax will be on the Government rather than the taxpayer. Under this provision, the burden will be on the Government in cases involving taxable years to which the Internal Revenue Code of 1939 applies in the case of proceedings tried on the merits after the date of enactment of this bill if the burden of proof would have been on the Government had the deficiency been such that section 534 of the 1954 Code (as originally enacted) applied.

"The relief that this provision will grant to taxpayers can be shown by comparison of the provisions for burden of proof under the 1939 Code as compared with the 1954 Code. Under the 1939 law if the Commissioner of Internal Revenue proposed a deficiency on the ground that the taxpayer has accumulated earnings and profits in excess of the reasonable needs of the business, the taxpayer had the burden of proof as to the reasonableness of the accumulation. If earnings and profits were accumulated in excess of the

reasonable needs of the business, the accumulation was deemed to be for the purpose of tax avoidance unless the taxpayer proved otherwise by the clear preponderance of the evidence.

"Under the 1954 Code the taxpayer may, upon receipt of notice of a proposed deficiency with respect to the accumulated earnings tax, file a statement of the grounds (together with sufficient facts to show the basis of the statement) on which the taxpayer relies to establish the reasonableness of the accumulation. If the taxpayer submits such a statement within the proper time, the burden of proof will be upon the Government as to whether the accumulation is in excess of the reasonable needs of the business. If the taxpayer does not file such a statement, it must bear the burden of proof as under prior law. Moreover, if the taxpayer's statement of the grounds relied upon fails to set forth the facts which show the basis thereof, the burden of proof with respect to these grounds must be borne by the taxpayer. If the Secretary or his delegate fails to give the taxpayer notification prior to the issuance of a notice of deficiency, then the Government must bear the burden of proof even though the taxpayer has filed no statement.

"The amendment made to section 534 of the 1954 Code by sections 4 and 5 of this bill will apply the provisions of the 1954 Code to all cases in which the proceedings are tried on the merits after the date of enactment of this bill [August 11, 1955]."

Applicable provisions of the Regulations promulgated May 12, 1959, under the August 11, 1955 amendment placing the burden of proof upon respondent are set forth in paragraphs 4754-B and 4754-D of the 1959 Prentice-Hall Federal Tax Service, as follows:

"Reg. (TD 6377, filed 5-12-59.) § 1.534-2. *Burden of proof as to unreasonable accumulations in cases*

before the Tax Court—(a) *Burden of proof on Commissioner.* Under the general rule provided in section 534(a), in any proceeding before the Tax Court involving a notice of deficiency based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, the burden of proof with respect to such allegation is upon the Commissioner if—

"(1) A notification, as provided for in section 534(b) and paragraph (c) of this section, has not been sent to the taxpayer; • • •

"Reg. (TD 6377, filed 5-12-59.) § 1.534-4. *Taxable years subject to the Internal Revenue Code of 1939.* The rules prescribed in §§ 1.534-1 to 1.534-3, inclusive, apply in any proceeding tried on the merits after August 11, 1955, before the Tax Court and involving a notice of deficiency in surtax imposed by section 102 of the Internal Revenue Code of 1939, for a taxable year subject to such Code, based in whole or in part on the allegation that all or any part of the earnings and profits of the taxpayer have been permitted to accumulate beyond the reasonable needs of the business. If a notice of deficiency for a taxable year described in the preceding sentence was mailed before September 11, 1955, a notification mailed before that date shall be effective as fully as though such notification had been mailed before the notice of deficiency was mailed."

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No. 839

In the Supreme Court of the United States

OCTOBER TERM, 1959

THE SMOOT SAND & GRAVEL CORPORATION,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The first memorandum findings of fact and opinion of the Tax Court (I R. 18a-55a) are not officially reported. The first opinion of the Court of Appeals (Pet. 1a-19a) is reported at 241 F. 2d 197, certiorari denied, 354 U. S. 922, rehearing denied, 354 U.S. 943. The second memorandum findings of fact and opinion of the Tax Court (I R. 57a-73a) are not officially reported. The second opinion of the Court of Appeals (Pet. 21a-39a) is reported at 274 F. 2d 495.

JURISDICTION

The judgment of the Court of Appeals was entered on January 11, 1960. (Pet. 40a.) Taxpayer's petition for rehearing was denied on February 24, 1960. (Pet. 41a.) The petition for a writ of certiorari was filed on April 7, 1960. The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

QUESTIONS PRESENTED

1. Whether the courts below erred in finding that, under Section 102 of the Internal Revenue Code of 1939, the corporate taxpayer accumulated earnings and profits during the years 1945-1950 for the purpose of preventing the imposition of surtax upon its shareholders and the shareholders of another corporation.

2. Whether the courts below erred in finding that the taxpayer had not shown that the reasonable needs of its business in the taxable years involved required more than amounts shown on its books as reserves.

3. Whether the Court of Appeals erred in finding that there was affirmative proof of an intention by the taxpayer to retain its net earnings for the purpose of avoiding the surtax upon its stockholders.

STATUTES AND REGULATIONS INVOLVED

The statutory provisions involved are Section 102 (a) and (c) of the Internal Revenue Code of 1939, and Section 534 of the Internal Revenue Code of 1954. These, and the relevant provisions of Sections 29.102-1, 29.102-2, and 29.102-3 of Treasury Regulations 111, are set out in the Appendix, *infra*, pp. 14-20.

STATEMENT

The facts, as stipulated and as found by the Tax Court (I R. 19a-41a), may be summarized as follows:

Taxpayer was organized in 1927. It owns and operates a sand and gravel business founded by L. E. Smoot in 1899. All of its capital stock is owned by Columbia Sand & Gravel Company, Inc. L. E. Smoot is the owner of all the common stock of the latter. He is also president of taxpayer and chairman of its board of directors. (I R. 19a-20a.)

Taxpayer has had net earnings in every year since 1927 in amounts ranging from $190,548.86 to $1,052,939.32. (I R. 38a, 43a.) It paid dividends of $20,000 in 1928 and $800,000 in 1932. It has paid no further dividends. (I R. 41a.) At the beginning of 1945, taxpayer had accumulated earnings and reserves of $6,197,061.88. At the end of 1945, it had cash of approximately $3,000,000 and Government obligations amounting to more than $1,300,000. Its balance sheets showed a surplus of $2,088,596.99 above its liabilities, which included the amount of $4,298,728.25 for reserves. (I R. 38a-39a.) The surplus increased to $2,908,702.60 at the end of 1950. (I R. 40a.)

The Commissioner determined that taxpayer was availed of during each of the years 1945 to 1950, inclusive, for the purpose of preventing the imposition of surtax upon its sole stockholder, Columbia Sand & Gravel Company, Inc., and on L. E. Smoot, through the medium of permitting its earnings and

profits to accumulate instead of being divided or distributed, thereby incurring liability for the surtax imposed by Section 102 of the Internal Revenue Code of 1939. (I R. 41a-42a.)

Taxpayer challenged this determination on the ground that its accumulated earnings were less than the amounts reasonably needed in its business, and that the amounts shown as reserves on its books did not reflect its actual needs. (I R. 42a.) The Tax Court held that taxpayer had not demonstrated that its needs were greater than those shown by the reserves on its books. (I R. 53a.) It considered the various items covered by these reserves—taxpayer's liability as a self-insurer (I R. 44a-46a); loans to customers (I R. 46a); needs for new plant and equipment, for postwar rehabilitation, and for sand and gravel replacement (I R. 46a-48a); a reserve for bonded indebtedness (I R. 49a-51a)—and held that taxpayer had not shown the existence of a plan for future expansion which would justify the retention of greater reserves. (I R. 46a-48a.)

Upon review, the Court of Appeals agreed with the Tax Court, with three exceptions. (Pet. 5a-19a.) One exception concerned a $250,000 reserve set up by taxpayer in lieu of obtaining performance bonds on its job contracts. The Court of Appeals pointed out that a bonded contractor still remains liable to his surety for performance of the contract, and that accordingly the fact that taxpayer did not use performance bonds did not increase the liability it would have had if bonded. It found no justification for this reserve. (Pet. 10a.) On two other items, the need

and amount of resources for entering the ready-mix concrete business (Pet. 11a-16a) and a determination of the amount of working capital needed (Pet. 16a-18a), the Court of Appeals remanded the case to the Tax Court for further findings (Pet. 19a).

On remand, following the denial of certiorari, the Tax Court found that taxpayer did not at any time during the years involved formulate any definite plan, make any commitments, or take any course of action preparatory to entering into the ready-mix concrete business; and that it has never at any time intended to enter into the ready-mix concrete business, at least unless forced to do so in order to protect its sand and gravel business. It further found that the taxpayer's business of producing and selling sand and gravel was not at any time under any threat which might reasonably have been regarded by its officers as likely to force the taxpayer to enter into the ready-mix business; and that, if any such threat ever existed, it did not extend beyond 1940 at the latest. Finally, it found that during the taxable period involved, the taxpayer's officers had no reasonable cause to consider entry into the ready-mix business as more than a remote possibility, or to accumulate the taxpayer's earnings and profits for that purpose (I R. 58a.)[1] The Court of Appeals accepted

[1] In its petition for certiorari (pp. 8-10), the taxpayer ignores these findings and quotes as the findings of the Tax Court its findings in its first opinion. In its second opinion, the Tax Court explains its first opinion and then expressly states (I R. 60a) that—

> If this is inconsistent with our previous findings, then, on the whole record as supplemented at the fur-

these findings. (Pet. 23a-28a.)[2]

On the remand, the Tax Court further found that the taxpayer's working capital needs for each year ran between $191,693.94 and $351,667.37. (I R. 67a.) In determining the taxpayer's total needs for such reserves, it allowed $500,000 for each year. (I R. 66a-68a.) The Court of Appeals accepted this figure as being more than enough. (Pet. 28a-29a, 35a.).

In determining the ultimate factual question whether the taxpayer was accumulating its earnings or profits beyond the reasonable needs of its business, the Tax Court accepted, for each year, the figure for surplus, consisting of surplus not earmarked and reserves shown on the books, taken from the stipulated balance sheets of the company (Pet. 38a-39a), and subtracted therefrom the "Reserves accepted as reasonable," plus "Loans to customers," and $500,000 for working capital. The difference, amounting to $1,515,679.99, on December 31, 1945, and rising steadily to $2,316,197.60 on December 31, 1950, it found to be the minimum unreasonable accumulation.

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ther hearing, we must regard those findings as erroneous, at least by implication, and accordingly revised as stated above.

[2] In its petition for certiorari (p. 11), the taxpayer states that the Court of Appeals "recognized that petitioner's 'officers sincerely believed that it would be forced into the ready-mixed concrete industry' during 1945-1950," and that "The Court of Appeals seemingly does not doubt that" this belief existed. The court's opinion, however, sets this out as the taxpayer's "main contention" (Pet. 25a), and proceeds to reject it (Pet. 25a-28a).

(I R. 67a-69a.) The Court of Appeals noted that the Tax Court was "overgenerous" in allowing $500,000 for the purchase of concrete mixing equipment, $500,000 for working capital, and $250,000 for contract bonds. (Pet. 35a.) It noted its own doubts as to the justification for the allowance of the large reserve of $1,333,000 for "post war rehabilitation." (Pet. 36a.) It agreed with the Tax Court's ultimate conclusion, stating it was "clearly correct." (Pet. 37a.)

In its second appeal to the Court of Appeals, the taxpayer argued that, in addition to the reserves of $1,333,000 for postwar rehabilitation and $100,000 for sand and gravel replacement, as set out on its books (Pet, 39a), it should also be entitled to deduct amounts covering depreciation, depletion, and bad debts. The court rejected this contention, pointing out that charges for bad debts, depreciation, and depletion had already been taken into account in determining the taxpayer's total assets and its surplus. (Pet. 32a-33a.) As to taxpayer's contention that it was entitled to a greater allowance for income tax liability, the court pointed out that there was an allowance for such liability, and that even if the taxpayer should be allowed a greater reserve it would not change the result in this case. (Pet. 33a-35a.)

This case arose under Section 102 of the Internal Revenue Code of 1939. Section 534 of the Internal Revenue Code of 1954 provides that in certain cases the burden of proof should be on the Commissioner. The Act of August 11, 1955, amended Section 534 to make it retroactive, but with a limitation that it

should apply only in the case of proceedings tried on the merits after August 11, 1955. This case was originally heard in June, 1954. (I R. 69a.) The Tax Court, in its second opinion, held this provision to be inapplicable to the present case. (I R. 69a-72a.) Assuming, however, that the burden of proof was on the Government, the Tax Court found that this burden was met by affirmative proof of "a deliberate, consistent and inescapable intention * * * to retain * * * net earnings for the purpose of avoiding the surtax upon its immediate and ultimate stockholders." (I R. 72a-73a.) The Court of Appeals agreed. (Pet. 37a.)

ARGUMENT

1. The purpose of Section 102 of the Internal Revenue Code of 1939 (Appendix, *infra*, p. 14) is to compel a company to distribute any profits not needed for the conduct of its business so that, when so distributed, individual stockholders will become liable for tax on the dividends received. *Helvering* v. *Stock Yards Co.*, 318 U. S. 693, 699. Its application depends upon the purpose for which the corporation was organized, or for which it was used during the taxable year. The inquiry whether the corporation is being used for the purpose of avoiding surtax on shareholders and whether accumulated profits are beyond the reasonable needs of the business is one of fact. *Helvering* v. *Nat. Grocery Co.*, 304 U.S. 282; *Helvering* v. *Stock Yards Co.*, 318 U.S. 693.

In this case, the Court of Appeals sustained the findings of the Tax Court, both as to the subsidiary facts and as to the ultimate factual question. Taxpayer is here seeking a second appellate review of factual issues which were fully argued and extensively considered in both courts below, and on which those courts are in agreement.

The petition for certiorari erroneously suggests that the Tax Court found the basic facts in accordance with the taxpayer's contentions, and that accordingly there is a conflict between the courts below. For example, the petition (p. 6) sets up a schedule purporting to show that the taxpayer had a deficit for each of the years 1945 through 1950, based upon its liabilities and reserves "found below." The fact is that the Tax Court found that the taxpayer had net earnings for each of those years (I R. 38a), and had surpluses, increasing during those years (I R. 68a). Indeed, one of the taxpayer's complaints in the Court of Appeals on the second review was that the Tax Court had *not* agreed that there were the deficits claimed. (I R. 19-28.)

The petition also states (p. 6) that the Tax Court "found" the cost to cover depreciation and replacement "was from $4,366,489.38 to $6,700,733.16," citing I R. 33a-34a. The Tax Court found nothing of the sort. It recited that the taxpayer, for purposes of this proceeding, had had an appraisal made in 1953 which contained these figures (I R. 33a-34a)—figures which the Tax Court did not accept (I R. 46a-47a).

Again, the petition states (p. 7) that the Court of Appeals held that the taxpayer was not entitled to accumulate "any earnings whatsoever" to replace its assets. This is not what the Court of Appeals held. It agreed that there could be accumulation for such replacement (Pet. 33a), and, with some doubts, allowed the sum of $1,333,000 (Pet. 36a).

The original findings of the Tax Court as to the ready-mix concrete business, set out in full in the petition (pp. 8-10), were expressly repudiated by the Tax Court and supplanted by its findings in its second opinion. The statements (Pet. 10) as to alleged threats to Mr. Smoot and pressure to use the anti-trust laws against him were rejected by the Court of Appeals (Pet. 25a). Again, as noted above, the petition errs in stating (p. 11) that the Court of Appeals "recognized" that taxpayer's officers sincerely believed that it would be forced into the ready-mixed concrete industry; the court was merely reciting the taxpayer's contention, which it rejected (Pet. 25a).

2. Taxpayer argues that the court below erred in not allowing any reserve for the replacement of exhausted assets. (Pet. 12-18.) This contention, however, ignores the fact that the court did recognize the need and did allow a reserve. Its opinion states (Pet. 33a):

> We are cognizant of the fact that replacement of taxpayer's wasting assets will ultimately become necessary, and that for this purpose cash or other liquid assets must be available; but, as will appear, taxpayer had much more liquidity than necessary for such replacement and for all other reasonable business needs.

Later, the opinion states (Pet. 36a):

> Thus, petitioner had liquid assets of more than $5,500,000, much in excess of what was reasonably required in the business (even after taking into consideration amounts necessary to replace depreciated and depleted property).

Furthermore, the reserves set up on the taxpayer's books, accepted by both courts (I R. 48a, 68a; Pet. 36a), contained an amount of $1,333,000 for future replacement of depreciated and depleted assets, and $100,000 for sand and gravel replacement (Pet. 39a). The Court of Appeals recognized the need for such a reserve and held that allowance of the $1,333,000 which taxpayer had itself set up on its books was more than reasonable. (Pet. 36a.)

The Court of Appeals, therefore, did precisely what the taxpayer is here contending it ought to have done—allow a reserve to replace exhausted assets. Taxpayer is merely asking this Court to reconsider the amount that should be allowed.[3]

2. The taxpayer's contention (Pet. 18-21) that the court should determine the question of unreasonable accumulation from the point of view of the years involved, and not from hindsight, ignores the fact that this was the test applied. The courts below determined the reasonable needs of the business as they appeared during the taxable years. (Pet. 7a-8a.) They agreed that "the controlling intention of the

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[3] In fact, the taxpayer did replace much of its equipment and acquire dredging rights during the years involved, out of current earnings or general surplus. (I R. 26a-27a, 36a, 47a.)

taxpayer is that which is manifested at the time of the accumulation * * *." (Pet. 7a.) In considering the ready-mix concrete question, both courts below examined the evidence and the facts as they appeared at the time in question. (I R. 59a-64a; Pet. 23a-28a.) The taxpayer is merely disagreeing with the weight given by those courts to the evidence.

3. Taxpayer's next contention (Pet. 21-24) is an invitation to this Court to redetermine the factual questions involved in the entire case. As pointed out above, the claimed deficits were not found to exist by the Tax Court, nor are they supported by the stipulated facts. The asserted deficits rest in part on a mathematical error, as pointed out by the Court of Appeals. (Pet. 32a-33a.) The amounts were obtained by subtracting from net assets all of the special or contingent reserves (I R. 34a) shown on the balance sheets (Pet. 39a), plus the accounting reserves for notes and accounts receivable, depreciable assets, and dredging rights (Pet. 39a; I R. 20-21). But, as pointed out by the Court of Appeals (Pet. 32a-33a), this last group of accounting reserves had already been deducted from the values for notes and accounts receivable, for depreciable assets, and for dredging rights (Pet. 38a).

4. The Court of Appeals held (Pet. 37a) that—

> even assuming that the burden of proof was on the Government, we are convinced, as was the Tax Court, that this burden has been met by affirmative proof of "a deliberate, consistent and inescapable intention to retain its net earnings for the purpose of avoiding the surtax upon its immediate and ultimate stockholders.

The petition misstates this as an "assumption" as to what the result might have been had there been a new trial. (Pet. 27-28.) As the opinion of the Court of Appeals shows on its face, no such assumption was made. The Court of Appeals, declining to decide whether the burden of proof had been shifted to the Commissioner, agreed with what the Tax Court had held (I R. 72a-73a), *i.e.*, that the burden, if there was one, was met. For a similar disposition of this problem, see *I. A. Dress Co.* v. *Commissioner*, 273 F. 2d 543, 544 (C. A. 2d), petition for certiorari pending, No. 832, October Term, 1959.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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MAY, 1960.

APPENDIX

Internal Revenue Code of 1939:

SEC. 102. SURTAX ON CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS.

(a) [as amended by Sec. 103(d) of the Revenue Act of 1941, c. 412, 55 Stat. 687] *Imposition of Tax.* There shall be levied, collected, and paid for each taxable year (in addition to other taxes imposed by this chapter) upon the net income of every corporation (other than a personal holding company as defined in section 501 or a foreign personal holding company as defined in Supplement P) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

27½ per centum of the amount of the undistributed section 102 net income not in excess of $100,000, plus

38½ per centum of the undistributed section 102 net income in excess of $100,000.

* * * *

(c) *Evidence Determinative of Purpose.*—The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary.

* * * *

(26 U.S.C. 1952 ed., Sec. 102.)

Internal Revenue Code of 1954:

SEC. 534. BURDEN OF PROOF.

(a) *General Rule.*—In any proceeding before the Tax Court involving a notice of deficiency based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, the burden of proof with respect to such allegation shall—

(1) if notification has not been sent in accordance with subsection (b), be on the Secretary or his delegate, or

(2) if the taxpayer has submitted the statement described in subsection (c), be on the Secretary or his delegate with respect to the grounds set forth in such statement in accordance with the provisions of such subsection.

(b) [as amended by Sec. 5 of the Act of August 11, 1955, c. 805, 69 Stat. 689] *Notification by Secretary.*—Before mailing the notice of deficiency referred to in subsection (a), the Secretary or his delegate may send by registered mail a notification informing the taxpayer that the proposed notice of deficiency includes an amount with respect to the accumulated earnings tax imposed by section 531. In the case of a notice of deficiency to which subsection (c)(2) applies and which is mailed on or before the 30th day after the date of the enactment of this sentence, the notification referred to in the preceding sentence may be mailed at any time on or before such 30th day.

(c) *Statement by Taxpayer.*—Within such time (but not less than 30 days) after the mailing of the notification described in subsection (b) as the Secretary or his delegate may prescribe by regulations, the taxpayer may submit a statement of the grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business.

(d) *Jeopardy Assessment.*—If pursuant to section 6861(a) a jeopardy assessment is made before the mailing of the notice of deficiency referred to in subsection (a), for purposes of this section such notice of deficiency shall, to the extent that it informs the taxpayer that such deficiency includes the accumulated earnings tax imposed by section 531, constitute the notification described in subsection (b), and in that event the statement described in subsection (c) may be included in the taxpayer's petition to the Tax Court.

(e) [as amended by Sec. 4 of the Act of August 11, 1955, *supra*] *Application of Section.*—

(1) Notwithstanding any other provision of law, this section shall apply with respect to taxable years to which this subchapter applies and (except as provided in paragraph (2)) to taxable years to which the corresponding provisions of prior revenue laws apply.

(2) In the case of a notice of deficiency for a taxable year to which this subchapter does not apply, this section shall apply only in the case of proceedings tried on the merits

after the date of the enactment of this paragraph.

(26 U.S.C. 534.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.102-1. *Taxation of Corporation Formed or Utilized for Avoidance of Surtax.*— Section 102 imposes (in addition to other taxes imposed by chapter 1) a graduated income tax or surtax upon any domestic or foreign corporation formed or availed of to avoid the imposition of the individual surtax upon its shareholders or the shareholders of any other corporation through the medium of permitting earnings or profits to accumulate instead of dividing or distributing them. However, personal holding companies, as defined in section 501, and foreign personal holding companies, as defined in Supplement P (see section 331), are excepted from taxation under section 102. The surtax imposed by section 102 applies whether the avoidance was accomplished through the formation or use of only one corporation or a chain of corporations. For example, if the capital stock of the M Corporation is held by the N Corporation so that the dividend distributions of the M Corporation would not be returned as income subject to the individual surtax until distributed in turn by the N Corporation to its individual shareholders, nevertheless the surtax imposed by section 102 applies to the M Corporation, if that corporation is formed or availed of for the purpose of preventing the imposition of the individual surtax upon the individual shareholders of the N Corporation.

* * * *

SEC. 29.102-2. *Purpose to Avoid Surtax; Evidence; Burden of Proof; Definition of Holding or Investment Company.*—The Commissioner's determination that a corporation was formed or availed of for the purpose of avoiding the individual surtax is subject to disproof by competent evidence. The existence or nonexistence of the purpose may be indicated by circumstances other than the evidence specified in the Internal Revenue Code, and whether or not such purpose was present depends upon the particular circumstances of each case. In other words, a corporation is subject to taxation under section 102 if it is formed or availed of for the *purpose* of preventing the imposition of surtax upon shareholders through the medium of permitting earnings or profits to accumulate, even though the corporation is not a mere holding or investment company and does not have an unreasonable accumulation of earnings or profits; and on the other hand, the fact that a corporation is such a company or has such an accumulation is not absolutely conclusive against it if, by clear and convincing evidence, the taxpayer satisfies the Commissioner that the corporation was neither formed nor availed of for the purpose of avoiding the individual surtax. All the other circumstances which might be construed as evidence of the purpose to avoid surtax cannot be outlined, but among other things the following will be considered: (1) Dealings between the corporation and its shareholders, such as withdrawals by the shareholders as personal loans or the expenditure of funds by the corporation for the personal benefit of the shareholders, and (2) the investment by the corporation of undistributed earn-

ings in assets having no reasonable connection with the business. The mere fact that the corporation distributed a large portion of its earnings for the year in question does not necessarily prove that earnings were not permitted to accumulate beyond reasonable needs or that the corporation was not formed or availed of to avoid surtax upon shareholders.

If the Commissioner determines that the corporation was formed or availed of for the purpose of avoiding the individual surtax through the medium of permitting earnings or profits to accumulate, and the taxpayer contests such determination of fact by litigation, the burden of proving the determination wrong by a preponderance of evidence, together with the corresponding burden of first going forward with evidence, is on the taxpayer under principles applicable to income tax cases generally, and this is so even though the corporation is not a mere holding or investment company and does not have an unreasonable accumulation of earnings or profits. However, if the corporation *is* a mere holding or investment company, then the Internal Revenue Code gives further weight to the presumption of correctness already arising from the Commissioner's determination by expressly providing an additional presumption of the existence of a purpose to avoid surtax upon shareholders, while if earnings or profits are permitted to accumulate beyond the reasonable needs of the business, then the Code adds still more weight to the Commissioner's determination by providing that irrespective of whether or not the corporation is a mere holding or investment company, the existence of such an accumulation is *deter-*

minative of the purpose to avoid surtax upon shareholders unless the taxpayer proves the contrary by such a clear preponderance of all the evidence that the absence of such a purpose is unmistakable.

* * * *

SEC. 29.102-3. *Unreasonable Accumulation of Profits.*—An accumulation of earnings or profits (including the undistributed earnings or profits of prior years) is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case. It is not intended, however, to prevent accumulations of surplus for the reasonable needs of the business if the purpose is not to prevent the imposition of the surtax. No attempt is here made to enumerate all the ways in which earnings or profits of a corporation may be accumulated for the reasonable needs of the business. Undistributed income is properly accumulated if retained for working capital needed by the business; or if invested in additions to plant reasonably required by the business; or if in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation. The nature of the investment of earnings or profits is immaterial if they are not in fact needed in the business. Among other things, the nature of the business, the financial condition of the corporation at the close of the taxable year, and the use of the undistributed earnings or profits will be considered in determining the reasonableness of the accumulations.

* * * *

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IN THE

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OCTOBER TERM, 1959

THE SMOOT SAND & GRAVEL CORPORATION, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

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REPLY BRIEF FOR THE PETITIONER

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MISCELLANEOUS:

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REPLY BRIEF FOR THE PETITIONER

Omissions from respondent's brief in opposition are of controlling significance, as follows:

1. It does not deny that the decision below is in direct conflict with the decisions of this Court in *Helvering* v. *National Grocery Co.*, 304 U.S. 282, 291, 82 L. Ed. 1346, 1354, *Knoxville* v. *Knoxville Water Co.*, 212 U.S. 1, 13, 53 L. Ed. 371, 380 and all other authorities unanimously holding that a business corporation is entitled to accumulate

earnings for replacement of depreciated and depleted operating assets.

2. It does not deny that the decision below is in direct conflict with the Second Circuit's decision in *Casey* v. *Commissioner*, 276 F. 2d. 26, 3 AFTR 2d 1440 (CA 2, 1959) holding (a) that the burden of proof should have been upon respondent and (b) that the test of reasonable needs is dependent upon the corporation's honest belief during the period involved rather than upon what may appear to others to have been reasonable on the basis of "second-guessing" hindsight many years later.

3. It does not deny that petitioner began business in 1927 with assets of more than $7,365,179.85 and had assets of only $7,003,917.83 at the end of 1945. It does not deny that during the 1945-1950 period petitioner's assets were not equal to the assets with which it began business in 1927 until 1947, even though its earnings were retained and substantially expended for tugs, barges and other business needs.

4. It does not deny that all retained earnings during petitioner's *entire existence* not expended in carrying on its business were *at all times* insufficient to pay its liabilities, as specifically found by the Tax Court, in 1945-1950.

5. It does not deny that due to inflation in the 1945-1950 period petitioner was approximately $2,000,000.00 worse off economically at the end of 1950 than at the beginning of 1945.

6. It does not deny that in determining reasonable business needs the Court of Appeals (a) refused to take into account either the prevailing prices ($4,366,489.38 to $6,700,733.16) of the 1945-1950 period required to replace admittedly exhausted operating assets or the stipulated replacement reserves ($2,041,378.29 to $2,358,419.03) based upon low prewar costs and (b) refused to take into account

income tax liabilities of $1,794,562.00. It does not deny that had petitioner's right to replace its exhausted assets been recognized on either basis and its income tax liability taken into account, the Court of Appeals would necessarily have held that petitioner suffered heavy accumulated earnings *deficits* during the entire 1945-1950 period.

7. It does not deny the accuracy of this statement at page 22 of the petition for certiorari:

> "It is solely by ignoring the specifically found replacement needs based on low prewar cost and the specifically found income tax liabilities that either Court below could reach the clearly erroneous crucial holding that petitioner had accumulated earnings beyond the reasonable needs of its business."

8. It does not deny that throughout two lengthy trials respondent called no witness to testify that petitioner had accumulated earnings beyond the reasonable needs of its business, even though it is clear (a) that petitioner's case was never considered on the merits by the Secretary or his delegate and (b) that deficiency notices were sent without being read by any official authorized to determine deficiencies.

9. It does not deny the accuracy of this statement at page 7 of the petition for certiorari:

> "When liquid assets only are taken into account, the reasonable business needs, as found by the Tax Court, including the necessity for replacing exhausted property, show that the 1945-1950 *deficits* in liquid assets on the Tax Court's own basis, ranged from $5,195,805.09 to $7,889,952.15."

10. It does not deny that on the basis of *undisputed* documentary proof and *unimpeached* testimony of ten of the ablest witnesses in the country, petitioner's total assets compared with its conclusively established reasonable needs as follows:

Year	Total Assets	Proven Reasonable Needs	Accumulated Earnings Deficits
1945	$7,003,917.83	$18,280,259.49	$(11,276,341.66)
1946	7,240,879.10	20,422,503.59	(13,181,624.49)
1947	7,624,693.11	23,347,239.63	(15,722,546.52)
1948	7,858,778.29	25,066,718.68	(17,207,940.39)
1949	7,880,412.59	24,203,644.03	(16,323,231.44)
1950	8,271,879.53	25,291,480.04	(17,019,600.51)

11. It does not deny that in direct violation of the August 11, 1955 amendment to Section 534 of the Internal Revenue Code of 1954, petitioner has been deprived of its *statutory right* to have its case (a) considered on the merits by the Secretary of the Treasury or his delegate and (b) tried and decided by the Tax Court with the burden of proof on respondent. *Casey* v. *Commissioner, supra.*

Misstatements in respondent's brief in opposition are also of controlling significance, as follows:

12. The brief (p. 6) states:

> "In determining the ultimate factual question whether the taxpayer was accumulating its earnings or profits beyond the reasonable needs of its business, the Tax Court accepted, for each year, the figure for surplus, consisting of surplus not earmarked and reserves shown on the books, taken from the stipulated balance sheets of the company (Pet. 38a-39a), and subtracted therefrom the 'Reserves accepted as reasonable,' plus 'Loans to customers,' and $500,000 for working capital."

This statement is incorrect. What the Tax Court did was to *find as a fact* that petitioner's reserves and liabilities ranged from $7,813,657.96 to $9,516,556.[illegible] in 1945-1950, including its reserves for depreciation, depletion, bad debts, and income tax liability ranging from $2,898,337.12 to $4,276,070.98. The Tax Court also *found as a fact* that petitioner's total assets ranged from only $7,003,917.83 to

$8,271,879.53 in 1945-1950. However, in its opinion it reached the conclusion of unreasonable accumulation by *entirely omitting* the $2,898,337.12 to $4,276,070.98 of specifically found income tax liability and reserves for depreciation, depletion and bad debts. Had this erroneous omission not been made it is perfectly clear, *with mathematical certainty*, that both the Tax Court and the Court of Appeals would necessarily have held that petitioner was in a heavy *deficit* position during the entire 1945-1950 period (Transcript Vol. I, 19-28).

13. The brief (p. 7) states:

> "In its second appeal to the Court of Appeals, the taxpayer argued that, in addition to the reserves of $1,333,000 for postwar rehabilitation and $100,000 for sand and gravel replacement, as set out on its books (Pet. 39a), it should also be entitled to deduct amounts covering depreciation, depletion, and bad debts."

This statement is incorrect and misleading. Petitioner has never argued that its inadequate reserve of $1,333,000 to cover extraordinary *repairs* bears any relation to, or has any connection with, the separate and distinct reserves on its balance sheet for *replacement* of assets lost through depreciation, depletion, and bad debts. The fact is, as found by the Tax Court, the actual amount required and expended for repairs was "approximately $3,811,600" (Vol. I, 6a, 25a). It is clearly erroneous to confuse *necessity for repairs* with *necessity for replacements*. The allowance of a reserve for repairs is clearly no answer to the serious error below whereby petitioner has been deprived of any right to reserves for replacement of assets lost through depreciation and depletion. Yet, the opposition brief is permeated with an attempt to have the reserve for repairs treated as a reserve for replacement. This is done despite the fact that the record establishes that the repair and replacement reserves are wholly unrelated.

14. In stating (Br. p. 7) that the Court of Appeals rejected petitioner's contention that it was entitled to have its bad debts, depreciation and depletion replacement reserves taken into account in determining reasonable needs, the opposition brief fails to point out that this holding was based *solely upon a newly enunciated rule of law to the effect that consideration of established replacement needs would constitute giving taxpayers the benefit of unallowable "double deductions"*. As shown by the affidavit of a Certified Public Accountant (Pet. 14-15) such holding is not in keeping with accounting principles and *undeniably* is in direct conflict with *Helvering* v. *National Grocery Co.*, *supra*, *Knoxville* v. *Knoxville Water Co.*, *supra*, and all other authorities.

15. Petitioner's contention is incorrectly stated at page 9 of the opposition brief. Petitioner's contention is that the opinions below are in direct conflict with the facts as specifically found below. It is perfectly clear that the Tax Court specifically found as a fact that petitioner's replacement reserves and income tax liability ranged from $2,898,337.12 to $4,276,070.98 in 1945-1950 and then completely overlooked, *without any explanation for so doing*, these specifically found reserves and liabilities in determining petitioner's reasonable business needs. The Court of Appeals has approved this unexplained oversight on the part of the Tax Court. Petitioner's position is that in so doing the Court of Appeals is in direct conflict with the decisions of this Court and all other authorities.

16. The alleged mathematical error referred to at page 12 of the opposition brief does not exist and never has existed. The Tax Court specifically found, itemized and tabulated the tax liabilities (Vol. I, 31a) and there is no basis for suggesting that a mathematical error exists with respect thereto (Vol. III, Petition for Rehearing, pp. 14-15).

17. Contrary to the statement at page 10 of the opposition brief, the Court of Appeals did recognize that peti-

tioner's officers sincerely and honestly believed that it was in imminent danger of being forced into the ready-mixed concrete business in 1945-1950, but held that such sincere and honest belief was not the test. The Court of Appeals' position was made clear on this point during oral argument. The Second Circuit's "honest belief" test enunciated in *Casey* v. *Commissioner*, *supra*, was dismissed as "just the Second Circuit's opinion." The Court made it clear that it would not follow the "honest belief" test but would apply the second-guessing hindsight reasonableness test as set forth in its opinion. *The direct conflict between the Second Circuit and the Fourth Circuit on this point is so glaring that respondent's brief neither discusses nor cites Casey* v. *Commissioner*, *supra*.

18. **It is of controlling importance to note:** From beginning to end the opposition brief does not mention, or make any attempt to defend or justify, the erroneous "double deduction" theory on the basis of which the Court of Appeals has refused to allow petitioner to accumulate any earnings to replace its admittedly exhausted operating facilities at either their low prewar cost or the inflated cost prevailing in 1945-1950. This newly stated "double deduction" theory is manifestly unsound and is in direct conflict with and complete disregard of the opinions of this Court and all other authorities. *Helvering* v. *National Grocery Co.*, *supra*, *Knoxville* v. *Knoxville Water Co.*, *supra*, Mertens, *Law of Federal Income Taxation*, Section 39.46, 1960 Prentice-Hall Federal Tax Service, p. 4718.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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May, 1960

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On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

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PETITION FOR REHEARING ON PETITION FOR A WRIT OF CERTIORARI

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PETITION FOR REHEARING ON PETITION FOR A WRIT OF CERTIORARI

Now comes petitioner, by its counsel, and respectfully asks that its petition for a writ of certiorari to the United States Court of Appeals for the Fourth Circuit, which was denied May 16, 1960, be reheard and reconsidered pursuant to Rule 58 on the basis of substantial grounds available to petitioner not previously presented.

I. The Court of Appeals Was Clearly and Understandably, But Mistakenly, Biased and Prejudiced Against Petitioner on the Second Appeal

With respect to reserves for depreciation, depletion and bad debts respondent's brief on the second appeal, at page 35, stated to the Court of Appeals as follows:

> "On this ultimate issue the taxpayer's fire is centered on the court's 'astonishing mistake' of overlooking the * * * reserves for depreciation, depletion, and bad debts. (Br. 3.) It argues that these should be taken into account and presents elaborate tables to show how subtraction of these amounts from 'Total Assets' would produce a deficit. (Br. 20-21.)
>
> "Insofar as depreciation, depletion, and bad debts are concerned, the taxpayer is simply, demonstrably, and obviously wrong. In the balance sheets (Appendix B, *infra*), the amount given for 'Total Assets' is computed only *after* the deduction of a reserve for notes and accounts receivable, a reserve for loans secured and insecured, a reserve for depreciation, and a reserve for depletion ('Dredging rights'). It is only the *net* amounts which are included in total a[illegible] Taxpayer in its table on pages 20-21 of its brief takes *this* figure of total assets and then deducts the same amounts a second time." (Respondent's italics)

Petitioner **did not** make a "subtraction" of reserves from total assets *at all* and **did not** deduct reserves a "second time". However, because of the above unfortunate misstatements to the contrary in respondent's brief, the Court of Appeals considered and decided this case on the second appeal with the *mistaken* firm conviction that petitioner had misstated the facts *when no such thing had occurred.* In the second opinion the Court of Appeals stated (App. 33a):

"* * * The taxpayer is thus totally incorrect when it claims additional reserves for bad debts, because the bad debt expense has already been eliminated from surplus; moreover, only the *net* receivables were considered by the court in evaluating the taxpayer's assets which are available for dividends.

"For the same reasons, the taxpayer's argument concerning the reserves for *depreciation and depletion* cannot be accepted. Surplus has already been reduced by annual charges to depreciation expense and to depletion expense; allowing them again would give the taxpayer double deductions. * * *" (Court's italics)

By petition for rehearing before the Court of Appeals (Vol. III, pp. 1-8 and 26-28) *petitioner conclusively demonstrated, both factually and by affidavit of a Certified Public Accountant, that it had not deducted "the same amounts a second time" for depreciation, depletion and bad debts, as stated in respondent's brief, and had not claimed "double deductions" for depreciation, depletion and bad debts as held by the Court of Appeals.* In other words, instead of being "totally incorrect", as stated by the Court of Appeals, petitioner's statement of the facts as to depreciation, depletion and bad debts *was 100% accurate.* However, *the harm had been done.* The Court of Appeals understandably was incensed because of its *mistaken* belief that petitioner had sought to mislead with respect to depreciation, depletion and bad debts.

There was no misstatement in petitioner's brief. Nevertheless, the Court of Appeals' unfortunate misconception that petitioner had misstated facts as to depreciation, depletion and bad debts was reflected in its opinion, *to petitioner's irretrievable detriment.*

It should be noted that *the "double deduction" theory*, on which the Court of Appeals refused to allow any accumulation of earnings to replace admittedly exhausted assets, is so *completely without foundation in fact or law* that respondent's opposition brief before this Court, unlike his brief below, did not mention, or make any attempt to defend or justify, the "double deduction" theory *on which the Court of Appeals was misled into erroneously deciding against petitioner on the crucial ultimate issue as to whether petitioner had accumulated earnings beyond the reasonable needs of its business.*

II. The Background of This Case Is Such That the Court of Appeals' Understandable, Though Groundless, Bias and Prejudice on the Second Appeal Was Clearly Fatal to Petitioner Because of the Court's Mistaken Belief on the First Appeal That Petitioner Had Not Presented Its Case With Integrity and Fairness

On the first appeal petitioner had no inkling as to the reason for the Court of Appeals' obvious hostility during the oral argument. It was not until the Court's first opinion was rendered that petitioner learned, through footnote 4, that the Court had passed upon the first appeal under the mistaken belief that petitioner's presentation was lacking in accuracy and integrity.

In footnote 4 the first opinion (App. 6a) made it clear that the case had been considered and decided by the Court of Appeals under the *misapprehension* (1) that petitioner had relied upon figures before the Court overstating the position taken before the Tax Court and (2) that "petitioner's brief and appendix abound in such discrepancies."

Petitioner conclusively demonstrated to the Court of Appeals that its case had been honestly presented with

meticulous accuracy and the Court deleted its wholly erroneous footnote 4 from the first opinion (App. 20a). There also, however, *the harm had been done* to petitioner's irretrievable detriment.

It is respectfully submitted that, in the light of the foregoing facts, the petition for a writ of certiorari should be granted to the end that petitioner may have the unbiased and unprejudiced appellate review to which it is entitled.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the petition for a writ of certiorari should be reheard and granted.

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Counsel for Petitioner

I, David R. Shelton, counsel for petitioner, do hereby certify that the foregoing petition for a rehearing in this case is presented in good faith and not for delay and that such petition for a rehearing is restricted to the substantial grounds above stated which were available to the petitioner although not previously presented.

DAVID R. SHELTON

June, 1960.